Supreme Court, U.S.
FILED
01-603 OCT 09 2001
OFFICE OF THE CLERK

No.

In The

Supreme Court of the United States

DELUXE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Public Law 86-272 deprives a State of the power to tax the income of a corporation engaged in business in that State where that corporation's only activity in the State is the solicitation of orders. The general rule in California is that the California income of a unitary group of corporations is assigned to each of the corporations, and taxed, based on each corporation's California activities. Nevertheless, where a corporation is immune from California taxation under Public Law 86-272, as in this case, California's taxing authorities employ a procedure that shifts the income earned by that corporation to the remaining taxable corporations of that group and then impose the franchise tax upon that shifted income. The question presented is the following:

Whether California's shifting income procedure "evades the purpose of [Public Law 86-272]," *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275, 279 (1972), and violates federal prohibitions against state taxation of a corporation's income if its sole in-state activity is the solicitation of orders.

LIST OF PARTIES

The parties are as stated in the caption.

RULE 29.6 STATEMENT

Deluxe Corporation does not have a parent company, nor does any other publicly held company own 10% or more of Deluxe Corporation's stock.

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PETITION FOR A WRIT OF CERTIORARI

Deluxe Corporation respectfully petitions for a writ of certiorari to review the judgment of the Court of Appeal of the State of California, First Appellate District, Division Two, in this case.

OPINIONS BELOW

The Opinion of the Court of Appeal (App. 1a) is not officially reported. The judgment and statement of the Superior Court of California, City and County of San Francisco (App. 13a), is not officially reported. The California Supreme Court's denial of Deluxe Corporation's petition for review (App. 37a) is not officially reported.

JURISDICTION

The judgment of the Court of Appeal was entered on April 26, 2001. (App. 1a.) The Supreme Court of California denied Deluxe Corporation's petition for review on July 11, 2001. (App. 37a.) The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Public Law 86-272, 15 U.S.C. § 381, provides in relevant part:

§ 381. Imposition of net income tax.

(a) Minimum standards. No state or political subdivision thereof, shall have power to impose, for any taxable year ending after [September 14, 1959], a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

. . . .

The Supremacy Clause of the United States Constitution, U.S. Const. art. VI, cl. 2, provides, in relevant part: "This Constitution, and the laws of the United States which shall be made in pursuance thereof . . . shall be the supreme law of the land; and the judges in every state shall be bound thereby, any thing in the Constitution or laws of any state to the contrary notwithstanding."

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides, in relevant part:

"The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

STATEMENT

When determining the California income of affiliated corporations engaged in a unitary business, California first uses formula apportionment to arrive at the group's California income. Next, California's general rule is to assign (and tax) that income to the individual corporations pro rata based on each corporation's California activities. However, where one or more of those corporations are immune from California tax under Public Law 86-272, California abandons this general rule and instead assigns the group's income only to the corporations that it can legally tax. It does this despite the fact, as in this case, that such income is apportioned to California based on the in-state, but nontaxable, activities of corporations protected by Public Law 86-272. As a consequence, California taxes the portion of the unitary group's income that is protected by Public Law 86-272. The State's position and the lower court's decision rest on the premise that, under the guise of apportionment of income of a unitary group, a State may tax the income otherwise protected by Public Law 86-272 or the Constitution.

A. Deluxe's Business

During the years in issue, Petitioner Deluxe Corporation ("Deluxe") manufactured and sold checks and business forms to businesses throughout the United States,

including California. Deluxe also operated manufacturing plants in California. There is no dispute that Deluxe was subject to California's income tax during the years in issue.

In addition, Deluxe engaged in a unitary business with two wholly-owned subsidiaries, Current, Inc. ("Current") and Colwell Systems, Inc. ("Colwell"). Current sold greeting cards, gift wrap, checks, and related items on a mail-order basis, and Colwell sold business forms also on a mail-order basis.

Current's principal place of business and all its employees and property were located in Colorado. Colwell's principal place of business and all its employees and property were located in Illinois. Current and Colwell each sent catalogs describing their products to California customers. Orders for Current's and Colwell's products were transmitted by fax, telephone, or mail to each company's offices located outside California, and all orders were filled by shipment from outside California. No other person or entity performed any activities in California on behalf of Current or Colwell. Although both Current and Colwell made sales to California customers, neither company was subject to the State's income tax. Public Law 86-272 precluded California from taxing the income of Current and Colwell. (Joint Stipulation of Facts ("JS") ¶ 18 and ¶ 22.)

B. California's Taxing Scheme and Assessment

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151,

23151.1. California employs a four-step process to determine the tax payable by corporate members of a unitary group: first, it determines the composition of the unitary group; second, it calculates the group's business income attributable to California; third, it determines the amount of the group's California income (by use of the three-factor formula); and fourth, it assigns the group's California income to each corporation so that it can be offset by losses and credits, and then if taxable, taxed.

In calculating the California taxable income of Deluxe, Respondent Franchise Tax Board ("FTB") first determined that Deluxe, Current, and Colwell were engaged in a unitary business. Deluxe agrees with this determination. Second, the FTB determined the unitary group's "pot" of business income subject to apportionment. There is no dispute that this amount was correctly determined, and that it properly included Current's and Colwell's business income.

Third, the FTB computed the unitary group's California income by formula apportionment. During the years in issue, the apportionment formula was the simple average of three fractions (also referred to as "factors"): the unitary group's in-state property over total property (the "property factor"), its in-state payroll over total payroll (the "payroll factor"), and its in-state sales over its total sales (the "sales factor"). Cal. Rev. & Tax. Code § 25128. Although neither Current nor Colwell was taxable by California, their California factors were included in the numerator of the formula. Deluxe agrees that the California apportionment percentage and the resulting California income accurately reflect the unitary group's activities in California.

Fourth, the FTB assigned the California income to the individual corporations. This assignment is necessary because the California franchise tax is imposed on individual corporations and not on the unitary group. *See, e.g., Edison Cal. Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947). The dispute in this case centers on the proper assignment of the unitary group's California income.

In general, the FTB's rule is to assign the California income based on the relative weight of each corporation's California activities. *See* Cal. Franchise Tax Bd., Legal Ruling No. 234 (Oct. 27, 1959) (reproduced at App. 47a). For example, if two corporations each account for 50 percent of a unitary group's California sales, payroll, and property, the group's California income apportioned to California would be assigned to each corporation on a 50-50 basis. However, if the general rule results in the assignment of income to a corporation that California cannot tax (for example, because of Public Law 86-272), the FTB abandons the general rule in favor of an arbitrary rule that assigns the immune California income *solely* to those corporations that are taxable – thereby shifting income from nontaxable corporations to taxable corporations. *See* Cal. Franchise Tax Bd., Notice No. 90-3 (June 8, 1990) (reproduced at App. 42a.)[1] Thus, in the previous

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[1] California recently promulgated a new rule that attempts to partially relieve the defect in California's method of assigning income on a going-forward basis. Cal. Code Regs. tit. 18, § 25106.5(c)(7)(B). However, the new administrative rule does not cure the defect where a taxpayer has California employees and/or property and is immune from tax in California. As a result, California's current practice continues to

example, if one corporation were immune from taxation by California, the group's California income would be assigned entirely to the remaining taxable corporation, even though the tax-immune corporation's factors provide the predicate for the apportionment of that income to California.

This shifting of income is explicitly illustrated by the examples contained in the FTB's Legal Ruling No. 234 (Oct. 27, 1959) and Notice No. 90-3 (June 8, 1990). (App. 47a and App. 42a, respectively.) The example set forth in Legal Ruling No. 234 establishes California's general rule: a unitary group's California income is assigned to each corporation, based on each corporation's relative California factors, *i.e.*, on a pro rata basis. Thereafter, each corporation reports its assigned income, offset by any separate losses, tax credits, etc., to determine whether any California tax is owed with respect to its assigned income. The example in Notice No. 90-3 describes an exception to the general rule. If, as in this case, one or

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circumvent the protection of Public Law 86-272. In addition, the decision of the lower court upholds California's tax scheme for all tax years ending prior to the change and leaves open the option for California to revert to the former rule. Furthermore, we are aware of four other States (Arizona, Indiana, Kansas, and Utah) that currently follow the rule employed by California during the years at issue. *See Airborne Navigation Corp. v. Ariz. Dep't of Rev.*, No. 395-85-I, 1987 Ariz. Tax LEXIS 34 (Feb. 5, 1987); Ind. Dep't of Rev., Informational Bulletin No. 12, 1988 Ind. Tax LEXIS 27, June 1988, *revised* Nov. 1993; Ind. Dep't of Rev., Tax Policy Directive No. 6, Ind. St. Tax Rptr. (CCH) ¶ 89-956, June 1, 1992; Kan. Dep't of Rev., Kan. Rev. Rul. 12-91-1, Kan. St. Tax Rptr. (CCH) ¶ 18-735, Feb. 1, 1991; and Utah Admin. Code 865-6F-24.

more of the corporations of the unitary group are immune from taxation, the income attributable to the nontaxable corporation under the general rule is assigned only to the corporations subject to tax. Thus, income that would have been assigned to a nontaxable corporation under the general rule, is instead shifted under the special rule to a corporation that California can tax. This income shift is made not because the income is not properly attributable to the nontaxable corporation, but *solely* because California cannot tax that corporation.

In this case, because Current and Colwell were immune from California tax under Public Law 86-272, California abandoned its general rule for assigning the group's California income and instead assigned, and taxed, all of that income (including that of Current and Colwell) to Deluxe, the only taxable member of the unitary group. Thus, the FTB increased Deluxe's income by $1,708,578 for 1988 and by $1,803,226 for 1989. (Supplemental Joint Stipulation of Fact, ¶ 32 and ¶ 35.) This resulted in tax deficiencies of $158,898 for 1988 and $167,700 for 1989. (*Id.*)

C. The Proceedings Below

In November 1997, Petitioner filed a suit for a refund of taxes and interest in the Superior Court, City and County of San Francisco. Petitioner alleged, among other things, that the FTB's method of computing Deluxe's California taxable income violated Public Law 86-272 and was preempted by federal law, including the United States Constitution.

(a) The Superior Court.

In May 1999, the Superior Court upheld the FTB's mechanism for assigning the California income of a unitary group to Deluxe. The court conceded that, "Deluxe provides numerous examples which accurately reflect how Deluxe is paying taxes on income generated in California by Current and Colwell." (App. 21a.) Nevertheless, the court concluded that the unitary business principle and formula apportionment, in effect, trump Public Law 86-272.

Upholding the tax upon the income attributable to Current and Colwell, the Superior Court relied principally upon the notion that the amount of a unitary business's income taxed by a State should not vary depending on whether the unitary business is conducted through separate divisions within a single corporation or separate corporations. Thus, the court concluded:

> Bearing in mind the purpose of treating members of a unitary group in the same manner regardless of the form of their organization, it is consistent to include the income of all members for purposes of apportionment and to divide the tax liability among only those members within the state's taxing jurisdiction. Clearly, Deluxe would be responsible for the tax burden of Current and Colwell if they were simply divisions of the Deluxe [C]orporation, rather than individually incorporated subsidiaries. Accordingly, the principles of combined reporting may reasonably be considered to demand similar treatment.

(App. 25a-26a.)

(b) The Court of Appeal.

In April 2001, the California Court of Appeal affirmed the decision of the Superior Court. Like the trial court, the Court of Appeal relied principally upon the theory that the unitary business doctrine and formula apportionment trump Public Law 86-272. (*See* App. 9a.) The Court of Appeal viewed the central issue as the proper apportionment of the unitary group's income to California. In the court's view, so long as the income apportioned to California reflects the income "attributable to California generated by the members of Deluxe's unitary group" (*id.*), California may tax that income without regard to Public Law 86-272.

(c) The California Supreme Court.

On July 11, 2001, the California Supreme Court denied Deluxe's petition for review. (App. 37a.)

REASONS FOR GRANTING THIS PETITION

The decision of the California Court of Appeal warrants review by this Court for two compelling reasons. First, in *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275, 279 (1972), this Court warned that if it were persuaded the State had evaded the intent of Public Law 86-272, "we would, of course, be reluctant to uphold its actions." This is just such a case. The tax scheme challenged here was applied by California *solely* because Current and Colwell were immune from taxation under Public Law 86-272. California treated the immune corporations as if they earned zero income in California and

instead shifted all of Current's and Colwell's California income to Deluxe. Indeed, as noted above, the trial court expressly confirmed that "Deluxe is paying taxes on income generated in California by Current and Colwell." (App. 21a.) This scheme is irreconcilable with the controlling federal law, which prohibits California from taxing the California income of Current and Colwell, and decisions of this Court, which provide that a State may not indirectly tax that which it cannot tax directly.

Second, review is necessary to resolve an important question involving Public Law 86-272, which one leading state tax scholar has described as "[t]he most important piece of legislation Congress has enacted limiting the states' power to tax interstate business. . . . " 1 J. Hellerstein & W. Hellerstein, State Taxation ("Hellerstein"), ¶ 6.16, pp. 6-46 (3d ed. 2001). The States are divided as to whether a State must abide by Public Law 86-272 in the context of affiliated corporations engaged in a unitary business.[2] Moreover, if allowed to stand, the Court of Appeal's decision would open a gaping hole in Public

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[2] *Compare Airborne Navigation*, 1987 Ariz. Tax LEXIS 34 (following California's position); Ind. Dep't of Rev., Tax Policy Directive No. 6 (to the same effect); Kan. Dep't of Rev., Rev. Rul. 12-91-1 (to the same effect); *and* Utah Admin. Code 865-6F-24 (to the same effect); *with Great N. Nekoosa Corp. v. State Tax Assessor*, 675 A.2d 963 (Me. 1996) (rejecting California's position in a similar context); *Dover Corp. v. Dep't of Rev.*, 648 N.E.2d 1089 (Ill. App. 1995) (to the same effect); *and* Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272 (2d rev. July 29, 1994) (indicating that the following States have rejected California's position: Arkansas, Colorado, Hawaii, Idaho, Louisiana, Montana, New Jersey, New Mexico, North Dakota, Oregon, and Rhode Island).

Law 86-272 and the constitutional structure that protects state taxpayers from illegal exactions. If Respondent is right, and the limitation of Public Law 86-272 can be circumvented merely by shifting immune income among members of a unitary group from nontaxable corporations to taxable corporations, even when such income is clearly earned by the nontaxable corporation, then the protection of Public Law 86-272 is illusory. Moreover, if the decision below is left undisturbed, it will pave the way for the States to avoid federal limitations on the States' taxing powers by doing indirectly that which they cannot do directly.

I. THE DECISION BELOW CONFLICTS WITH FEDERAL LAW AND SETTLED DECISIONS OF THIS COURT THAT A STATE MAY NOT DIRECTLY OR INDIRECTLY TAX INCOME OF A CORPORATION WHOSE ONLY ACTIVITY IN THE STATE IS THE SOLICITATION OF ORDERS FOR TANGIBLE PERSONAL PROPERTY

The practical effect of the FTB's position and the lower court's decision is to tax income that is exempt from taxation under Public Law 86-272. This conclusion follows from three essentially undisputed propositions. First, the parties have stipulated that California could not tax the California income of Current or Colwell because those corporations were protected by Public Law 86-272. (JS ¶ 18 and ¶ 22.) Second, as the trial court determined, "Deluxe [paid] taxes on income generated in California by Current and Colwell." (App. 21a.) Third, solely because of the nontaxable status of Current and Colwell,

all of the unitary group's California-source income, including that earned by Current and Colwell, was assigned entirely to Deluxe and taxed by California.

As noted above, the California Court of Appeal viewed the essential dispute in this case as the proper apportionment of the unitary group's income to California, even though Petitioner never disputed that the amount of income apportioned to California was proper. Relying principally on *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403, 1415, 100 Cal. Rptr. 2d 509 (2000), *cert. denied*, ___ U.S. ___, 121 S. Ct. 2623 (2001), the court determined that so long as the income apportioned to California reflects the income "attributable to California generated by the members of Deluxe's unitary group" (App. 9a), California may tax that income without regard to Public Law 86-272.[3] The court was unconcerned with the obvious fact that the California income earned by Current's and Colwell's California sales was protected by Public Law 86-272. In short, simply because the State sent the tax bill to Deluxe, and not Current and Colwell, the State did not, in the court's view, impermissibly tax the income of those immune corporations. Such a rule, however, flies in the face of Public Law 86-272 and the Constitution.

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[3] The Court of Appeal's reliance on *Citicorp*, however, is misplaced. The *Citicorp* decision is inapposite in this case since that case did not involve the violation of Public Law 86-272 raised here, and the relevant issue before the Court of Appeal was whether California constitutionally could include the sales of nontaxable corporations in the sales factor of the apportionment formula, an issue that Petitioner has conceded in this case.

A. A State Simply Cannot Tax Income over Which It Has No Power to Tax, Even if Such Income Is Properly Apportioned to the State

Formula apportionment is merely a device for determining the amount of income of a unitary group that is attributable to activity within a State, *see, e.g., Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 223 (1980); it is not determinative of whether the State has the power to tax such income. Indeed, it is an axiomatic principle of state taxation that a State may only tax income or property that is within its taxing power. *See, e.g., Miller Bros. Co. v. Maryland*, 347 U.S. 340, 342 (1954) ("It is a venerable if trite observation that seizure of property by the state under pretext of taxation when there is no jurisdiction or power to tax is simple confiscation and a denial of due process of law"); *see also New York, Lake Erie & W. R.R. Co.* v. *Pennsylvania*, 153 U.S. 628, 646 (1894); *St. Louis v. Ferry Co.*, 78 U.S. 423, 430 (1871). Congress, in exercising its power to regulate interstate commerce, limited the States' power to tax a corporation's income from interstate commerce if the corporation's sole activity in the State is the solicitation of orders. 15 U.S.C. § 381; *see also Heublein*, 409 U.S. at 278; *Wis. Dep't of Rev. v. William Wrigley, Jr., Co.*, 505 U.S. 214, 223 (1992).

It is, of course, "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the Constitution to do directly." *Passenger Cases*, 48 U.S. 283, 458 (1849) (plurality opinion). This Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions

that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty of tonnage," U.S. Const. art. I, § 10, cl. 3); *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 464-65 (2000) (striking down a rule that increased the amount of taxable income – through the reduction of a deduction – by precisely the amount of nontaxable income that the taxpayer has received, as an "impermissible tax"); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643, 645 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

California's method of determining Deluxe's taxable income in this case is a paradigmatic example of a State's effort to tax indirectly that which it cannot tax directly. Under California's tax scheme, if Deluxe, Current, and Colwell were all taxable by California, the State would have assigned part of the unitary group's California income on a pro rata basis to each corporation and determined any tax separately for each corporation. *See* Cal. Franchise Tax Bd., Legal Ruling No. 234 (App. 47a). However, solely because of Current's and Colwell's tax immunity, the State employed the artifice that those corporations earned zero income in California, and arbitrarily shifted their California income to Deluxe. *See* Cal. Franchise Tax Bd. Notice No. 90-3 (App. 42a). There is no

logical or reasoned basis for this latter rule other than to strip income from nontaxable corporations and assign it to a taxable corporation. Because the shifting of income from Current and Colwell depends solely on the taxability of those corporations, the effect is simply to tax the income of immune corporations.

B. California's Tax Scheme Evades the Letter and Spirit of Public Law 86-272

There is little doubt that California's tax scheme operates to evade the letter and the spirit of Public Law 86-272. In this case it has been stipulated that Public Law 86-272 prevents California from taxing Current's and Colwell's California income. Thus, it is clear that California cannot circumvent the mandate of Public Law 86-272 by creating the fiction that Current and Colwell earned none of the group's California income and Deluxe earned all of such income. Indeed, even the trial court in this case readily acknowledged this effect: "Deluxe provides numerous examples which *accurately reflect how Deluxe is paying taxes on income generated in California by Current and Colwell*" (Statement of Decision, App. 21a (emphasis added)), and "It is undeniable that Current and Colwell have contributed to the unitary group's California source income." (*Id.* at App. 25a.) By shifting income from an immune corporation to a taxable corporation, the amount of a unitary group's income taxed by California remains the same regardless of whether a portion of that income is earned by a corporation immune from taxation under

Public Law 86-272. This is a clear violation of Public Law 86-272.

In *Heublein*, 409 U.S. 275, this Court recognized that States could easily circumvent the protection of Public Law 86-272 to evade the intent of Congress, and thus warned that "[i]f we were persuaded that South Carolina has evaded the intent of [Public Law 86-272] we would, of course, be reluctant to uphold its actions." *Id.* at 279. In that case, the Court considered whether a state law that required out-of-state sellers of alcoholic beverages to maintain an in-state representative to receive orders violated the intent of Public Law 86-272 by forcing out-of-state companies to engage in activities exceeding the mere solicitation of goods. This Court determined that the regulation did not offend or evade the intent of Public Law 86-272 because of the state's special interest in regulating the sale of alcoholic beverages and because the regulation was merely a part of a broad regulatory scheme. The Court's warning, however, served to put States on notice that circumvention of the protections of Public Law 86-272 would not be tolerated.

This Court's warning is directly applicable in this case. It is undeniable that the challenged rule "evades the purpose" of Public Law 86-272. California's rule deprives a corporation of the protection of Public Law 86-272. However, the rule at issue here has none of the redeeming features of the South Carolina law upheld in *Heublein*. California's rule is not part of a broad regulatory scheme, and it serves no purpose other than to allow California to tax income protected by Public Law 86-272.

In sum, there simply is no justification or reasoned basis for a rule that assigns income on a pro rata basis to Current and Colwell if they are taxable, but shifts their income to Deluxe if those corporations are immune from tax. As this Court once put the matter, "a tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citation omitted). Similarly, a tax on Deluxe measured by the California income of Current and Colwell is a tax on Current and Colwell.

II. THE QUESTION PRESENTED HAS WIDESPREAD SIGNIFICANCE AND SHOULD BE RESOLVED TO AVOID UNDERMINING FEDERAL RESTRAINTS ON STATE TAXATION

The issues raised here potentially affect every multistate taxpayer in the country as well as every State that uses the unitary method of taxation. Public Law 86-272 is an important federal limitation on states' taxing power and was enacted with the primary purpose of bringing clarity to when a State may tax interstate commerce. *See Heublein*, 409 U.S. at 280. The lower court's decision destroys that clarity and threatens to render the protections afforded by Public Law 86-272 merely illusory.

Moreover, if a State is permitted to circumvent Public Law 86-272 simply by shifting income from an immune corporation to a taxable corporation, all federal limitations on the states' taxing power would be at risk. In this particular instance, if allowed to stand, the Court of Appeal's decision provides a roadmap for evading the

restrictions of Public Law 86-272. If a State can reach nontaxable income by the transparent device of shifting such income from a nontaxable corporation to a taxable corporation, then the bar on taxing such nontaxable corporations is meaningless. Yet that is precisely what California has done.

The impact of the Court of Appeal's decision is not merely theoretical. More than 40,000 corporations have filed income tax returns reporting activities inside and outside California, and thus are potentially affected by the lower court's decision. In addition, at least 14 States utilize the unitary business/formula apportionment method of taxation. *See* Hellerstein, *supra* at ¶ 8.11[3], p. 8-194 n. 819. If the decision below is left undisturbed, it will pave the way for every State to avoid Public Law 86-272, as well as the constitutional limitations on its taxing powers. The decision below, after all, stands for a proposition of astonishing breadth: A State may increase a taxpayer's income merely by shifting income from a nontaxable corporation to a taxable corporation, even where it is clear that such income is attributable to the nontaxable corporation's activities. Moreover, the States are well aware of this issue – at least four other States have adopted tax schemes similar to that at issue here (*see* footnote 1), and California's rule has been the topic of frequent discussion in the state tax literature.[4]

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[4] *See, e.g.*, Ruurd G. Leegstra & Fred O. Marcus, *Joyce Overturned – Justice Denied?*, Journal of California Taxation, Summer 1990, at 5, and Pierre Vogelenzang, *Second-Stage Apportionment of Unitary Income*, Tax Notes, Oct. 15, 1990, at 335.

In short, the decision below has implications not only for every state taxpayer engaged in a unitary business, but also for state tax administrators. Unless quickly repudiated, the California Court of Appeal's decision will allow California to tax income that is immune under federal law, and is likely to embolden other States to follow California's lead. In these circumstances, this Court should grant review of the decision below.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX A

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE
STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION TWO

DELUXE CORPORATION,	
Plaintiff and Appellant,	**A088142**
v.	**(City & County of S.F. Super. Ct. No. 991237)**
FRANCHISE TAX BOARD,	
Defendant and Respondent.	**(Filed Apr. 26, 2001)**

I.

INTRODUCTION

In this corporate franchise tax refund case, Deluxe Corporation (Deluxe) sought to recover from the Franchise Tax Board (FTB) a refund of $638,269.34, plus applicable interest, for income years ending December 31, 1988, and December 31, 1989. Deluxe appeals from a decision of the superior court after a nonjury trial in favor of the FTB. We affirm the trial court's judgment. We conclude, as did Division One of this district in *Citicorp North America, Inc. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403 (*Citicorp*), that in calculating the amount of income apportionable to California operations under the rule in effect at the time Deluxe filed its tax return, the FTB properly included the California sales of

Deluxe's wholly owned subsidiaries, even though they did not have a taxable nexus to California.

II.

Facts and Procedural History

The facts of this case are not in dispute. The parties submitted a joint stipulation of facts to the trial court regarding the relevant facts, which are summarized as follows:

Deluxe is a corporation organized and existing under the laws of Minnesota, with its principal place of business in Minnesota. During the years at issue – income years ending December 31, 1988, and December 31, 1989 – Deluxe primarily manufactured and sold checks to businesses throughout the United States. Deluxe also sold financial forms to financial institutions and operated manufacturing plants. Deluxe was a California taxpayer and filed California tax returns.

Deluxe was engaged in a unitary business[1] with several corporations, including two wholly owned subsidiaries, Current, Inc. (Current) and Colwell Systems, Inc. (Colwell). Current was a Delaware corporation that conducted a mail order business, with all of its property and employees located at its principal place of business in the State of Colorado. Colwell was a Delaware corporation that conducted a mail order business, with all of its

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[1] A unitary business is one that receives income "from or attributable to sources [both] within . . . [and] . . . without the state . . . ." (Rev. & Tax Code, § 25101.) All further undesignated statutory references are to the Revenue and Taxation Code.

property and employees located at its principal place of business in the State of Illinois. Neither Current nor Colwell was subject to California's franchise or income tax during the years at issue.

Deluxe timely filed California franchise tax returns on a combined basis for the years at issue. Under the unitary method of taxation as applied by California, the business income of each entity is included in the combined report, and an apportionment formula is applied to the unitary business income to derive the group's income from California sources. (See generally *Safeway Stores, Inc. v. Franchise Tax Board* (1970) 3 Cal.3d 745, 751-752.) Upon audit, the FTB recomputed the corporate franchise tax liability of Deluxe and its affiliates after determining the California business activities of the Deluxe unitary group had been miscalculated.

As a result of the FTB's actions, Deluxe filed suit for a tax refund in the San Francisco Superior Court. In doing so, Deluxe sought to recover from the FTB a refund of $638,269.34 corporate franchise tax and interest paid for the taxable years ending December 31, 1988, and December 31, 1989. The parties submitted a joint stipulation and exhibits to the trial court regarding the relevant facts. After a court trial was held, the trial court issued a statement of decision, deciding in favor of the FTB in all respects. Pursuant to a stipulation of the parties, Deluxe was awarded the refund of an overpayment of interest in the amount of $11,579. Deluxe has appealed.

III.

Discussion

Background on Different Methods of Income Apportionment

The various questions presented by this appeal relate to the formula by which the Board determined what portion of Deluxe's multi-state unitary business income was properly attributable to California sources and subject to California franchise taxes. If a unitary business exists, taxes are apportioned by formula so that California can recover "its fair share of the taxable values of the taxpayer . . . ." (*Butler Brothers v. McColgan* (1941) 17 Cal.2d 664, 667-668, aff'd. (1942) 315 U.S. 501 (*Butler Brothers*).) In calculating corporate franchise taxes of a unitary interstate business, the FTB apportions the business income attributable to California by means of a complex three-factor formula based on property, payroll and sales. (§ 25128.)

In the disputed returns, Deluxe excluded the California sales of Current and Colwell from the apportionment formula used to determine the portion of the unitary group's business income attributable to California sources because Current and Colwell were not California taxpayers. In excluding Current and Colwell's California sales from the apportionment formula sales calculation, Deluxe was following the rule first enunciated by the State Board of Equalization (SBE) in *Appeal of Joyce, Inc.* (Nov. 23, 1966) [1966-1971 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 203-523, pp. 13,115-13,118) (hereafter *Joyce*). The *Joyce* opinion held that sales to California customers by an out-of-state seller who was not subject to California

tax in its individual capacity would be excluded in the apportionable tax base even though the out-of-state seller was part of a unitary group, which included another member subject to California tax. In following the *Joyce* method of apportionment, Deluxe attributed less income to its California activities and concomitantly reduced its California tax liabilities.

After an audit, the FTB determined that, consistent with the rule then being applied by the FTB, the California sales of Current and Colwell should be included in the apportionment formula used to determine the portion of Deluxe's business income attributable to California sources. The FTB's determination was guided byhe [sic] method of apportionment regarding unitary business groups enunciated in the SBE's ruling in *In re Appeal of Finnigan Corporation* (Aug. 25, 1988) Cal. Tax Rptr. (CCH) [1986-1990 Transfer Binder] ¶ 401-653, pp. 25,241-25,243 (hereafter *Finnigan I*); opn. on petn. for rehg. (Jan. 24, 1990) Cal. Tax Rptr. (CCH) [1986-1990 Transfer Binder] ¶ 401-797, pp. 25,755-25,757 (hereafter *Finnigan II*) (opinions collectively referred to as *Finnigan*). *Finnigan* was a 1990 SBE decision that specifically overruled *Joyce* and applied its ruling retroactively to the tax years at issue in this case, 1988 and 1989. *Finnigan* held that *Joyce* contravened fundamental unitary tax theory by preventing assignment of an out-of-state corporation's sales to a destination state where at least one unitary group member was subject to tax in the state. On June 8, 1990, the FTB issued FTB "Notice No. 90-3," which affirmed the ruling in *Finnigan* and overruled the *Joyce* doctrine. In following the *Finnigan* method of apportionment, the FTB treated all Deluxe affiliates as a unitary taxpayer and

included income generated in California by Current and Colwell in the apportionment formula because Deluxe, a member of the unitary group, was taxable in the state even though Current and Colwell were not themselves taxable.

Thereafter, the SBE issued its opinion in *In re Appeal of Huffy Corporation*, (Cal. State Tax Rptr. (CCH) 1995-1999 transfer binder, [¶] 403-031). In *Huffy*, the position established in *Finnigan* was abandoned and the rule established in *Joyce*, was prospectively readopted for income years beginning on or after April 22, 1999. *Joyce* was readopted to more fairly reflect fundamental principles of unitary business group combined reporting, and to promote Uniform Division of Income for Tax Purposes Act (UDITPA) consistency.[2] The ruling's prospective rather than retroactive application recognized past reliance on the *Finnigan* decision and deprived Deluxe of the benefit of the *Joyce* rule.

Was it Error to Use the Finnigan Income Apportionment Methodology in this Case?

Primarily, Deluxe argues that the method the FTB used to compute its tax set forth in the *Finnigan* decision was unlawful because it had the effect of taxing Deluxe with respect to income derived from Current and Colwell, sources beyond the taxing jurisdiction of the State. Deluxe argues: "This was accomplished by assigning all

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[2] The UDITPA has been adopted by over 20 states and was enacted in California in 1966. The expressed general purpose of UDITPA is to standardize state corporate income tax laws and to make uniform the law of those states that enact it. (§ 25138.)

of the group's California apportioned income, including that of Current and Colwell, entirely to Deluxe, simply because Deluxe was taxable by California while Current and Colwell were not. Appellant challenges this assignment as indirectly taxing Current's and Colwell's income in violation of [Pub.L. No.] 86-272[3] and the Commerce and Due Process Clauses of the United States Constitution." (Footnote added.)

Any need to analyze the myriad of arguments made by Deluxe in support of its position on appeal has been made unnecessary by Division One's recent decision in *Citicorp*, a case that mirrors the one before us. Our Supreme Court recently denied review of *Citicorp* on January 10, 2001. In *Citicorp*, the Court of Appeal ruled that credit card sales to California customers by Citicorp's South Dakota affiliate, which was not itself taxable in the state, were properly included in the measure of Citicorp's California taxpayers' income attributable to California sources and that doing so did not unconstitutionally tax the income of the South Dakota affiliate. In so ruling, the court considered and rejected the bulk of the arguments raised by Deluxe herein to application of the *Finnigan* rule of apportionment. We hereby adopt the well-reasoned analysis of *Citicorp* and find that analysis effectively disposes of the arguments made by Deluxe on appeal.

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[3] Public Law No. 86-272 allows a company to solicit sales in a state without becoming subject to taxation in that state as long as the order acceptance, the order filling, and shipment are in another state. Under Public Law No. 86-272, these sales are "thrown back" to the shipping state for taxation, rather than being included in the destination state for taxation.

Most importantly, *Citicorp* gave an unmistakably clear answer to the main argument made by Deluxe in this appeal – that the *Finnigan* rule of apportionment is inconsistent with federal and state law because it results in unconstitutional taxation. The *Citicorp* court unanimously repudiated Citicorp's contention that the *Finnigan* rule of apportionment amounts to an illegal, "indirect" tax on the income of the South Dakota affiliate. In doing so, the court relied on *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472 (*Edison*), which held "that to compute the income allocable to one state of a unitary business operated in several states by a reasonable formula method is not to tax extraterritorial values." (*Id.* at p. 483, citing *Butler Brothers, supra,* 315 U.S. at p. 507.) Invoking *Edison*'s reasoning, *Citicorp* concluded that, "by considering the California income of Citibank (South Dakota), the FTB is not taxing, but is apportioning income attributable to California. [Citation.] Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction." (*Citicorp, supra,* 83 Cal.App.4th at p. 1415.) The court found *Edison* to be "a clear response to Citicorp's claim that consideration of the out-of-state affiliate's California activity results in extraterritorial taxation." (*Ibid.*, fn. omitted.)

In so holding, *Citicorp* reaffirmed the long-established distinction between apportionment of income and the taxation of income. Recognizing this distinction, the court determined that the income of Citibank (South Dakota) was not being taxed indirectly by California, but was simply being considered in the measure of tax, i.e., in determining the amount of Citicorp's business income attributable to California sources. The court's opinion

reflects its understanding that the *Finnigan* rule is fully consistent with the fundamental notion that the unitary business principle does not implicate a state's jurisdiction to tax, but addresses only the subject of apportionment, i.e., the proper measure of a unitary group's level of business activity in the state.

Consequently, for purposes of apportionment of unitary business income in a combined report, it is simply irrelevant whether California has a jurisdictional nexus to tax Current and Colwell, or any other member of Deluxe's unitary group. The underlying premise of formula apportionment is to arrive at an amount that fairly reflects the taxpayer's business activity in California. By applying principles of combined reporting and formula apportionment, California seeks only to determine the income attributable to California generated by the members of Deluxe's unitary group. As recognized by *Citicorp*, "Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction." (*Citicorp, supra*, 83 Cal.App.4th at p. 1415.) In short, by applying the *Finnigan* methodology, California does not seek to tax any individual member of Deluxe's unitary group not otherwise subject to tax in the state.

Furthermore, we accept *Citicorp*'s holding that UDITPA's stated objective of making uniform the law of those states which have enacted its provisions represents nothing more than a stated goal. Although certainly a legitimate objective, uniformity does not constitute an independent legal ground on which to invalidate a method of apportionment. As the *Citicorp* court stated: "[t]he mere fact that other bodies and jurisdictions did not follow the *Finnigan* rule is not a valid basis for this

court to disregard the considered decision of a constitutionally created quasi-judicial administrative agency." (83 Cal.App.4th at p. 1418.)

The *Citicorp* court also rejected the argument that the FTB's application of the *Finnigan* rule violated the commerce clause, the due process clause and the equal protection clause of the United States Constitution. In considering the constitutional claim, Citicorp stated "[t]here was no evidence indicating that application of *Finnigan* distorted the percentage of income fairly allocable to California. Rather, the evidence reflected the reasonable apportionment of sales generated in California." (83 Cal.App.4th at p. 1425.) Furthermore, exposure to duplicative taxation resulting from a lack of uniformity among the states does not present a constitutional question. The court observed, "Prevention of such possibilities of duplicative taxation would require adoption of a national uniform code, a task the court found better suited to an exercise of the legislative, than the judicial power. [Citations.] Plainly, the Constitution does not mandate that every state treat every item of income alike and assign the apportionment of sales in a uniform manner." (*Ibid.*) Thus, when a state's method of apportionment represents a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing state, no constitutional violation exists.

The *Citicorp* decision also addresses Deluxe's fallback argument that "assuming, arguendo, that the FTB's method of apportionment and assignment of income [pursuant to *Finnegan*] does not violate Cal. Rev. & Tax. Code § 25138, [Pub.L. No.] 86-272 or the Constitution,

nevertheless that methodology should not be applied retroactively to the years at issue." In *Citicorp*, the court undertook a thorough and thoughtful analysis of the administrative history of the SBE's decisions in *Joyce*, *Finnigan*, and *Huffy*. (83 Cal.App.4th at pp. 1412-1414.) The court traced the initial adoption of the *Joyce* rule in 1966, the abandonment of the *Joyce* rule in favor of *Finnigan* in 1988, and the recent return to the *Joyce* rule in *Huffy*. The court recognized the SBE's flip-flop in its decisions "is not evidence that either interpretation was legally impermissible. [Citation.]" (*Id.* at p. 1419.) While acknowledging that the *Finnigan* rule was eventually abandoned, the court resoundingly rejected Citicorp's claim that *Finnigan* was poorly reasoned and should be given no weight. To the contrary, *Citicorp* found the "SBE decision in *Finnigan* was supported by reference to the relevant statutes and regulations, and a reasoned analysis of the issues." (*Id.* at p. 1420.) With regard to the FTB's decision, pursuant to Notice 90-3, to apply *Finnegan* retroactively, the court noted, "[r]etroactive application of *Finnigan* was an exercise of the prevailing rule regarding changes in the law." (*Id.* at p. 1423.) In short, the court rejected Citicorp's request to "adjust the agency's reasoned resolution of the application of its own rules." (*Id.* at p. 1424.)

Therefore, in accordance with the reasoning in *Citicorp*, we hold the apportionment methodology applied by the FTB to the years at issue under the *Finnigan* rule was fairly calculated to assign to California that portion of the unitary enterprise's income reasonably attributable to the business done here. This conclusion remains true even in light of the fact that the FTB has abandoned the

Finnigan approach and reverted to *Joyce*. Deluxe therefore is not entitled to any refund of the taxes it has paid for the years at issue.

IV.

Disposition

The judgment is affirmed.

Ruvolo, J.

We concur:

Kline, P.J.

Lambden, J.

APPENDIX B

IN THE SUPERIOR COURT OF
THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF SAN FRANCISCO

DEPARTMENT NUMBER 304

Deluxe Corporation, a Minnesota Corporation, Plaintiff, vs. Franchise Tax Board, an agency of the State of California, Defendant.	Case No. 991237 STATEMENT OF DECISION (FILED MAY 26, 1999)

Plaintiff, Deluxe Corporation ("Deluxe") seeks to recover from defendant, Franchise Tax Board ("FTB"), a refund of $638,269.34 corporate franchise tax and interest paid for the taxable years ended December 31, 1988 and December 31, 1989. The matter was submitted based on a Joint Stipulation of Facts ("JS"), from which the summary set forth below is drawn. All facts pertain to the income years ending December 31, 1988 and December 31, 1989.

Summary of the Facts

Deluxe is a corporation organized and existing under the laws of Minnesota, with its principal place of business in Minnesota. (JS ¶ 1.) Deluxe primarily manufactured and sold checks to businesses throughout the United States. (JS ¶ 5.) Deluxe also sold financial forms to financial institutions and operated manufacturing plants. (JS

¶ 5.) Deluxe was a California franchise tax payer, and timely filed California franchise tax returns. (JS¶ 7.)

Deluxe was engaged in a unitary business with several corporations, including two wholly-owned subsidiaries, Current, Inc. ("Current") and Colwell Systems, Inc. ("Colwell"). (JS ¶s 6, 15, 19.) Current was a Delaware corporation which conducted a mail order business, with all of its property and employees located at its principal place of business in Colorado. (JS ¶ 15.) Colwell was a Delaware corporation which conducted a mail order business in the State of Illinois. (JS ¶ 19.) Neither Current nor Colwell was subject to California's corporation franchise or income tax during the years at issue because the activities of Current and Colwell in California did not exceed the activities described in subsections (1) and (2) of 15 U.S.C. §381(a) ["Public Law 86-272"]. (JS ¶ 18.)

During the years at issue, Deluxe filed California franchise tax returns and determined its California net income by preparing a combined report. (JS ¶ 7.) The combined report included the business income of all members of the Deluxe unitary group. (JS ¶ 7.) Pursuant to the method of apportionment set forth in *Appeal of Joyce*[1] and FTB Legal Ruling No. 234, Deluxe excluded the California sales of Current and Colwell from the numerator of the California sales factor used to determine the portion of the unitary group's business income attributable to California sources. (JS ¶8.)

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[1] *Appeal of Joyce, Inc.*, Cal. St. Bd. of Equal., November 23, 1966

After an audit, the FTB determined that pursuant to the method of apportionment set forth in *Appeal of Finnigan*[2] and FTB Notice 90-3, the California sales of Current and Colwell should be included in the numerator of the California sales factor used to determine the portion of the unitary group's business income attributable to California sources. (JS ¶ 9.)

Pursuant to FTB Notice 90-3, the FTB then assigned all of the unitary group's California apportioned business income to Deluxe, the member of the unitary group taxable in California, and assigned none of that income to Current and Colwell. (JS ¶ 23.) None of the group's California income was assigned to Current or Colwell because they were not taxable by California. (JS ¶24.)

Background Information

The California franchise tax is essentially a tax measured by the net income of a corporation for the privilege of doing business in California. (Rev. & Tax Code §§ 23151, 23151.1.) California employs the "combined reporting method" or "unitary method" of corporate taxation to determine a corporation's California net income. (*Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 162-163.)

The unitary method of taxation involves three steps. First, the corporate taxpayer must determine with which

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[2] *Appeal of Finnigan Corporation* [*Finnigan I*], No. 88-SBE-022, Cal. Tax RPTR. (CCH) ¶ 401-652 (Aug. 25[,] 1988), and *opinion on reh'g., Appeal of Finnigan Corporation* [*Finnigan II*] No[.] 88-SBE-022-A, Cal. Tax Rptr. (CCH) ¶ 401-797 (Jan. 24, 1990).

affiliated corporations, if any, it is engaged in a unitary business. Second, the taxpayer must determine the unitary group's business income. Third, the taxpayer must apportion the corporation's unitary business income to determine its California taxable income. (*Id.* at 165.)

The apportionment of the unitary group's business income is itself a four step process which involves the application of a statutory three-factor apportionment formula. In Step One, the three-factors which are used in the apportionment formula are calculated. (Cal. Rev & Tax. Code §25128.) These are a sales factor, a property factor, and a payroll factor. Only the sales factor is at issue in this case. The sales factor is a fraction consisting of California sales in the numerator, and aggregate world-wide sales in the denominator. In Step Two, the fractions for each of the three factors are added together and divided by three to derive an average of the three factors. In Step Three, referred to as "interstate apportionment," the resulting apportionment fraction is multiplied by the unitary group's business income to derive the business income apportioned to California. In Step Four, referred to as "intrastate assignment," the business income apportioned to California is assigned to the individual members of the unitary group.

Prior to 1990, the method of apportionment utilized by the FTB was consistent with the method urged by Deluxe. From 1966 until 1990, the FTB applied the *Joyce* Rule. (JS ¶ 24.) Under *Joyce*, the California sales of a member of a unitary group immune from California tax under Public Law 86-272, are excluded from the numerator of the California sales factor.

In 1990, the FTB changed its practice and began employing the methodology set forth in the *Finnigan* decisions and FTB Notice 90-3. Under the new practice, if any member of the unitary group is taxable in California, the California sales of all members of the unitary group are included in the numerator of the California sales factor.

Recently, the FTB has tentatively adopted a new regulation, section 25106.5 of Title 18 of the California Code of Regulations, which expressly adopts the *Joyce* rule and rejects the apportionment methods in *Finnigan* and Notice 90-3, thus reverting to the pre-1990 policy.[3] This regulation is now in a 45-day notice period, to allow for public comment and an opportunity for further hearings. See also *Appeal of Huffy* (1999) 96R-1263, pp. 15-16, *infra*.

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[3] The latest FTB change of policy is of little relevance to the outcome of this matter. The unitary business concept is flexible and susceptible to varying interpretations. (*Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, 167 ("A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.")) As long as the approach employed by the FTB at any given time satisfies the constitutional requirements, is consistent with applicable federal and state statutes, and is uniformly applied, the methodology will be upheld. The FTB has the flexibility to change methodology as it sees fit.

Discussion

Deluxe, as the plaintiff, has the burden of affirmatively establishing a right to a tax refund by a preponderance of the evidence. (*Consolidated Accessories Corp. v. Franchise Tax Bd.* (1984) 161 Cal.App.3d 1036, 1039.) Deluxe has attempted to carry that burden by challenging the apportionment scheme utilized by the FTB for the years in question as a violation of Public Law 86-272 and of the Commerce and Equal Protection Clauses of the United States Constitution.

I. Did the Board of Equalization in *Finnigan* improperly determine the meaning of "taxpayer" for purposes of the throw-back rule?

As a preliminary argument, Deluxe contends that in *Finnigan* the Board of Equalization improperly read "taxpayer" to include any member of the unitary group for purposes of the throw back rule. (Cal. Rev. & Tax. Code §25135(b)(2).)[4] The throw back rule relates to the computation of the sales factor of the apportionment formula. Ordinarily, sales of tangible personal property made to California customers are assigned to California under the "destination rule". However, such sales are assigned, or "thrown back", to the shipping state if the seller is not

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[4] Section 25135(b[])(2) reads in pertinent part:

Sales of tangible personal property are in this state if:

(b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) . . .or (2) the taxpayer is not taxable in the state of the purchaser.

taxable in California. Under *Joyce*, the throw back rule was applied where the individual taxpaying corporation was not subject to tax in the destination state. However, under *Finnigan*, California sales should not be thrown back to the shipping state if any member of the unitary group was subject to tax in California.

In *Finnigan I* the court stated:

> "We believe that basic unitary theory requires us to conclude that, as used in section 25135, subdivision (b)(2), "taxpayer" means all corporations within the combined unitary group. To hold otherwise would result in an apportionment formula which produced a different tax effect where the unitary business was conducted by the divisions of a single corporation than where it was conducted by multiple corporations. No difference is discernible in the two situations. The California Supreme Court has told us that as far as unitary theory is concerned the same rule should apply whether the integral parts of the unitary business are or are not separately incorporated. (*Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 473.)" (*Appeal of Finnigan*, No. 88-SBE-022, 1988 Cal. Tax LEXIS 28, 6.)

Deluxe argues that this interpretation of "taxpayer" is inconsistent with the plain language of Section 25135 and the surrounding sections of the Uniform Division of Income for Tax Purposes Act (UDITPA). Deluxe asserts that "all of the substantive and definitional provisions embodied in UDITPA, which determine the share of a taxpayer's income that is attributable to California, refer to the taxpayer or a taxpayer in the singular."

The FTB, however, refers to a number of sections in UDITPA which define taxpayer to include not only individual corporations but also all corporations within a unitary group. One example relied upon by the FTB is Section 25121, which provides that any taxpayer having income from business activity which is taxable both within and without the state shall apportion its net income as provided in the UDITPA provisions.

This court must agree with the observation in *Finnigan* that "it is apparent that the term taxpayer as used in UDITPA is multifaceted." (*Id.* at 6.) If otherwise required, the term is broad enough to include all of the members of a unitary group.

II. Does the apportionment methodology set forth in FTB Notice 90-3 violate Public Law 86-272?

FTB Notice 90-3, which draws its authority from the *Finnigan* decisions, provides that if any member of a unitary group is taxable in California, the California sales, property, and payroll factors of all members of the unitary group are included in the numerators of the respective California factors. The resulting California apportioned business income is then assigned to those members of the unitary group subject to tax in the State.

Public Law 86-272 (15 U.S.C. §381) prohibits a state from imposing a tax on income derived from the sale of tangible personal property where (1) the seller's only activity in the state consists of the "solicitation of orders," (2) the orders are sent out of state for approval, and (3) delivery/shipment is made from a point outside the state. The parties have stipulated that the activities of Current

and Colwell in California did not exceed the activities described in Public Law 86-272 and, accordingly, they were not subject to taxation in California.

Deluxe contends that under the FTB's approach, the same amount of the unitary group's income is taxed as would occur without the subsidiaries' tax immunity, so that the FTB has effectively manipulated the apportionment formula to tax indirectly income which California cannot tax directly. (See *Frick v. Pennsylvania* (1925) 268 U.S. 473.) To illustrate this point, Deluxe provides numerous examples which accurately reflect how Deluxe is paying taxes on income generated in California by Current and Colwell. The FTB acknowledges that "the effect of the *Finnigan* rule is that California destination sales of Current and Colwell, entities exempt from taxation under Public Law 86-272, are considered in determining the amount of income of the unitary group which is apportioned to California but that those sales are disregarded when the California source income is divided between the members of the group actually subject to taxation by the process of intrastate apportionment." (FTB Trial Brief at p. 29.)

In *Finnigan II*, the court specifically addresses the dramatic change in reasoning from the earlier *Joyce* decision:

> To those well versed in unitary matters, Joyce undeniably contravenes fundamental unitary theory in two important respects. First, by forbidding the assignment of sales to the state of destination in situations where at least one member of the unitary group is taxable in that state, but the actual seller is not, the Joyce rule

> defeats the basic purpose of the sales factor, which is to reflect the markets for the unitary business's goods and services. (see Altman and Appeals of Pacific Telephone and Telegraph Company, Cal. St. Bd. of Equal., May 4, 1978.) Second, by focusing on the state's jurisdiction to tax the seller as a separate corporate entity, the rule elevates form over substance by yielding a different apportionment result dependent solely on whether the unitary business is conducted by several corporations or only by one.

This court agrees that FTB notice 90-3 does not impermissibly tax the income of an immune entity. Public Law 86-272 is directed to the authority of a state to impose a tax, and places a limit on that power where a particular corporation limits its contact with a state to certain specified activities:

> "No State . . . shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: . . ."

The statute does not expressly prohibit a state from using the income of a non-taxable entity for purposes of apportionment if another member of a unitary group of which it is a part conducts the requisite in-state activity. Nor is the apparent intent of the statute inconsistent with treating the unitary group as a whole for purposes of apportioning a corporation's taxable income to a particular state. If some member of the group conducts the requisite degree of activity within a state such as California, that member of the unitary group has subjected itself to the taxing authority of that state, and apportionment of the

unitary group's income to that taxpayer would not seem to circumvent the spirit of the statute, so long as the apportionment formula is reasonable. Only if the non-taxable entity is in fact independent of any other entity subject to the state's taxing authority would the purpose of the statute seem to preclude the state from considering the non-taxable entity's income in this manner. Certainly Deluxe has not cited any case law or legislative history indicating that such apportionment contravenes the statute.[5]

Instead, Deluxe contends that unitary theory does not sanction disregard of the form of corporate organization, observing that in other situations corporations with multiple divisions may be taxed differently than those with separately incorporated subsidiaries. To illustrate this point, Deluxe provides a number of examples in which taxation varies depending on the organization of the corporations.[6] Notwithstanding these examples,

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[5] To the contrary, see *Airborne Navigation Corporation v. Arizona Department of Revenue* (1987) No. 395-85-I Arizona Board of Tax Appeals, holding that appellant did not qualify for the exemption provided by Public Law 86-272 because the unitary group had sufficient business presence in Arizona to be subjected to Arizona taxing jurisdiction. In reference to the immunity provided by Public Law 86-272 the court stated that it would not be stretching the definition of "person" in the statute to say that appellant and the other corporations in the unitary group could be considered one person.

[6] For example, Deluxe cites to Cal. Rev. & Tax Code §§ 24401 and 24416 which allow for a deduction for net operating losses carried forward from a previous year. Such deductions are available to an individual corporation, and its various divisions, but not to offset income of other separately incorporated members of the unitary group.

adherence to this distinction is not required. (*Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472.) In discussing the applicability of unitary apportionment theory to corporate groups with differing forms of organization, the court in *Edison* stated:

> Thus the business is unitary regardless of the fact that in the *Butler Brothers* case there was but one corporation involved, owning as parts of the unitary system seven different branches in as many states, and that in the present case there is a parent corporation owning and controlling as units of one system fifteen different branches organized as corporations in as many states. No difference in principle is discernible. If the crux of the matter is to ascertain that portion of the business which is done within the state, then the same considerations justify the use of the formula allocation method in one case as in another.

Additionally the court observed:

> The ascertainment of income by the apportionment method is not necessarily a disregard of the corporate entity. . . [.] Formula allocation is merely a method of ascertaining the true income attributable to the plaintiff's business, and is a method of ascertainment authorized by the statute.

Unitary theory and formula apportionment are based on the principle that all corporations engaged in a unitary business should be treated as a single economic enterprise for state tax purposes. The unitary business principles of formula apportionment attempt to eliminate the complications of particular corporate relationships and

impose a "fair and reasonable" tax result.[7] Thus, it does not matter that one member of the unitary group is not subject to tax in a particular state. Its income and activities within that state nonetheless will be considered when determining the in-state income for those members of the unitary group that are subject to the state's taxing jurisdiction. It is undeniable that Current and Colwell have contributed to the unitary group's California source income. Therefore, the inclusion of their income in the apportionment formula is consistent with a rational application of unitary theory.

Finally, Deluxe contends that even if this court decides that the *Finnigan* decisions are correct, Notice 90-3 reaches impermissibly beyond the holding in *Finnigan* when it assigns the entire California share of the unitary group's income to Deluxe. This argument, however, ignores the reasoning behind the *Finnigan* decisions.

The intrastate assignment in Notice 90-3 effectuates the change enunciated in *Finnigan*. Were the state to proportionally assign a unitary group's income among the corporations comprising the group and apply a tax only on those who were California taxpayers, there would be no difference in the results derived under *Joyce* and under *Finnigan*. Bearing in mind the purpose of treating members of a unitary group in the same manner regardless of the form of their organization, it is consistent to include the income of all members for purposes of apportionment and to divide the tax liability among only

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[7] See Corrigan, "Finnigan's Wake or Joyce's? The Application of Unitary Principle to Combined Groups,["] 1 J. Cal. Tax. 5 (1989).

those members within the state's taxing jurisdiction. Clearly, Deluxe would be responsible for the tax burden of Current and Colwell if they were simply divisions of the Deluxe corporation, rather than individually incorporated subsidiaries. Accordingly, the principles of combined reporting may reasonably be considered to demand similar treatment.

II. Does the apportionment scheme set forth in FTB Notice 90-3 violate the Commerce Clause?

The United States Supreme Court set forth the test for determining when a state tax violates the Commerce Clause in *Complete Auto Transit, Inc. v. Brady*[,] 430 U.S. 274, 279 (1977). The test requires that a state tax should be sustained "against Commerce Clause challenge when the tax is [1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." Deluxe raises challenges under the first three prongs of the *Complete Auto* test.

These challenges fail primarily because they rest upon a misunderstanding of unitary theory. This theory requires that the unitary group be viewed as a whole, the purpose being to effect the same tax treatment regardless of how the unitary group is internally organized.

A. *A substantial nexus exists between the unitary group and California such that taxation is proper.*

Deluxe contends that the apportionment methodology in FTB Notice 90-3 violates the first prong of the *Complete Auto* test because Current and Colwell do not have a substantial nexus with California such as to justify taxation. Substantial nexus essentially means that there be "some definite link, some minimum connection, between a state and a person, property or transaction it seeks to tax." (*Miller Bros. v. Maryland*, 347 U.S. 340, 344-345 (1954).) Deluxe's argument on this issue relates back to the earlier argument that the FTB is taxing Current's and Colwell's income indirectly via Deluxe.

For the same reasons discussed above, this argument is not persuasive. First, the inclusion of Current's and Colwell's sales income in the apportionment formula is not the imposition of a tax on Current and Colwell. Second, a substantial nexus does exist between the unitary group and California such that the inclusion of all California sales in the apportionment formula is permissible.

B. *The resultant tax is fairly apportioned.*

Deluxe contends that the apportionment methodology in FTB Notice 90-3 violates the second prong of the *Complete Auto* test because the resultant tax is not fairly apportioned. The fair apportionment requirement essentially means that the apportionment formula must have internal and external consistency. (*Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, 169.)

Internal consistency means simply that the formula, if applied by every jurisdiction, would not result in more than 100% of the unitary business' income being taxed. (*Ibid.*) External consistency means that the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. (*Ibid.*)

Deluxe argues that "[b]ecause only Deluxe's income is taxable by California, by importing Current's and Colwell's California sales into the formula used to apportion the unitary group's income to California and by then assigning all of the apportioned income solely to Deluxe, including that generated by Current and Colwell, the FTB has forsaken any claim that it simply has effected a "reasonable" apportionment of Deluxe's income. Additionally, Deluxe argues that the arbitrary assignment of all of the California income to Deluxe is not reflective of Deluxe's activities in California, and thus is out of all "appropriate proportion" to those activities.

Applying the *Container* test, there is no doubt that the apportionment formula has internal consistency. While the unitary group's California liability may increase, there would be a matching reduction in Colorado and Illinois source income, such that no more than 100% of the unitary group's income would be taxed. Furthermore, the formula is externally consistent in that the factors used – sales, property and payroll in the state – do reflect the means by which income is generated.

Deluxe's arguments to the contrary are not persuasive. The principles of unitary reporting require that the unitary group be taken as a whole. As such, the inclusion

of the income of Current and Colwell in the apportionment formula and the assignment of the resultant tax liability to Deluxe does not produce a result out of all proportion to their business conducted in California. In fact, the result is quite the opposite: it properly reflects a reasonable apportionment of the unitary group's California income, as calculated by accepted unitary business principles.

C. *Notice 90-3 does not discriminate against interstate commerce.*

Deluxe argues that the apportionment methodology in FTB Notice 90-3 discriminates against interstate commerce "by favoring those taxpayers that affiliate with corporations subject to tax in California over taxpayers that chose not to affiliate with corporations taxable in California," thereby violating the third prong of the *Complete Auto* test. (Deluxe's Trial Brief, p.17.) Specifically, by including Current's and Colwell's sales in the apportionment formula and then assigning the tax liability to only Deluxe, the individual tax liability of Deluxe increases simply because Current and Colwell are not California taxpayers.

Deluxe relies primarily upon *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) in support of this contention. In *Fulton*, the Supreme Court invalidated a North Carolina taxing scheme which imposed an intangibles tax upon corporate stock, but allowed for a deduction equal to the percentage of the underlying corporation's income taxable within North Carolina. The Court stated that "[t]here is no doubt that the intangibles tax facially discriminates

against interstate commerce. A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." Deluxe argues that, like the tax in *Fulton*, FTB Notice 90-3 "improperly coerces taxpayers like Deluxe to affiliate with California based corporations and discourages corporations subject to tax in California from investing in or otherwise affiliating with out-of-state corporations without taxable nexus with this State." (Deluxe's Trial Brief, p.20.)

Fulton, however, is distinguishable. The facts in *Fulton* do not involve unitary principles. In *Fulton*, the tax on an individual corporation's stock varied depending on the state of incorporation. Here, looking at Deluxe, Current and Colwell as part of a unitary group, the total tax on the group does not depend on their different states of incorporation. When the unitary group is viewed as a whole, the state's policy does not discriminate against interstate commerce. As such, the policy is not facially discriminatory.

This conclusion is further supported by the Court's additional comments in *Container Corporation of America v. Franchise Tax Board, supra*, 463 U.S. 159:

> Besides being fair, an apportionment formula must, under the Commerce Clause, also not result in discrimination against interstate or foreign commerce. Aside from forbidding the obvious types of discrimination against interstate or foreign commerce, this principle might

> have been construed to require that a state apportionment formula not differ so substantially from methods of allocation used by other jurisdictions in which the taxpayer is subject to taxation as to produce double taxation of the same income and resultant tax burden higher than the taxpayer would incur if its business were limited to any one jurisdiction. At least in the interstate commerce context, however, the antidiscrimination principle has not in practice required much in addition to the requirement of fair apportionment. (*Id.* at 170, internal citations omitted.)[8]

As discussed above, the state's policy is both internally and externally consistent and does not facially discriminate against interstate commerce. Accordingly, Deluxe's challenge under the Commerce Clause cannot prevail.

III. Does the apportionment scheme set forth in Notice 90-3 violate Equal Protection?

Deluxe acknowledges that "taxation ordinarily does not involve 'any suspect classification or the deprivation of any fundamental constitutional right' that gives rise to special scrutiny under the Equal Protection Clause. *See Harrah Indep. Sch. Dist. v. Martin* (1979) 440 U.S. 194, 199."

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[8] The Court felt that a contrary result would require the Court to establish "not only a single constitutionally mandated method of taxation, but also rules regarding the application of that method in particular cases." (*Id.* at 171.) Because this task was thought to be essentially legislative, the Court declined to adopt this approach. (*Ibid.*)

(Deluxe's Trial Brief at p. 24.) Accordingly, the rational basis standard is applied to measure the constitutionality of a particular tax under the Equal Protection Clause.

Nonetheless, Deluxe argues that Notice 90-3 creates an arbitrary and irrational classification based on whether or not a corporation is affiliated with other corporations subject to tax in California. (Deluxe's Trial Brief at p. 25.) This is essentially the same argument raised under the Commerce Clause: that Notice 90-3 discriminates against corporations who affiliate with non-California taxpayers. As discussed above, this is not correct.

Under the theories of combined reporting, the FTB properly considered the sales of Deluxe's affiliates in determining the portion of the unitary group's income attributable to California sources. The relevant tax, levied on Deluxe, is rationally related to the unitary business principles which treat the business operations of all unitary group members as contributors in income generated in California. Accordingly, there is no Equal Protection violation.

IV. *Appeal of Huffy* (1999) 96R-1263

Deluxe requests that the statement of decision be enlarged to address the recent decision by the State Board of Equalization in the *Appeal of Huffy Corporation* (1999) 96R-1263. A decision of the State Board of Equalization, as an administrative agency of the state, is persuasive but not binding on this court. "While an interpretation put forth by an administrative agency charged with enforcement, implementation and interpretation of enactments is

entitled to great weight, a court may properly accept or reject it according to the validity of its reasoning, its consistency, and all those factors which give it power to persuade, if lacking power to control." (*Rain Bird Sprinkler Mfg. Corp v. Franchise Tax Bd.* (1991) 229 Cal.App.3d 784, 791-792, internal citations omitted.)

In *Huffy*, the Board rejected the *Finnigan* apportionment rule and adopted prospectively the rule from *Joyce*. The primary reason for doing so was that, contrary to the Board's prior expectations, the vast majority of other taxing jurisdictions did not adopt the *Finnigan* rule. (*Appeal of Huffy Corporation*, 96R-1263, p. 5.) "Although there was the hope that with the adoption of the *Finnigan/NutraSweet* line of cases, the new apportionment rule would lead to a more theoretically sound application of the unitary method, there has been academic criticism of the actual result. . . . While there were theoretically good reasons for the initial implementation of the *Finnigan/NutraSweet* rule, the actual practice has resulted in taxation of income which would not otherwise be taxed by the State of California." (*Id.* at 5-6.) In an effort to promote uniformity in the application of the UDITPA, the Board decided to revert to the pre-*Finnigan* method of apportionment. (*Id.* at 6.) This decision, however, is to apply only prospectively, to income years beginning on or after April 22, 1999, the date of the *Huffy* decision. (*Id.* at 8.)

Deluxe reads *Huffy* as further support for its contention that the *Finnigan* rule indirectly taxes income in violation of Public Law 86-272. That, however, is not the holding in *Huffy*. The decision in *Huffy* is based on the practical application of two methods of apportionment

and the desirability of consistency between the various taxing jurisdictions. The Board did not alter its position because it determined that the *Finnigan* rule is contrary to the federal statute or constitutional principles. Indeed, the fact that the Board made its decision apply only prospectively reinforces the conclusion that changes in the state's method of taxing unitary groups are permissible and do not invalidate the method used in prior years.

CONCLUSION

For the reasons set forth above, the reasoning in the *Finnigan* decisions is sound and the apportionment methodology in Notice 90-3 is fairly calculated to assign to California that portion of the net income reasonably attributable to the business done here. This conclusion remains true even if the FTB reverts to the *Joyce* approach in subsequent years. Deluxe therefore is not entitled to any refund in the taxes it has paid, and judgment should be entered for the defendant.

Counsel for defendant should prepare and submit a judgment approved as to form by counsel for plaintiff.

Dated: 5/26/99

/s/ Stuart R. Pollak
Stuart R. Pollak
Judge of the Superior Court

Superior Court of California
City and County of San Francisco

DELUXE CORPORATION, a Minnesota Corporation, Plaintiff(s) vs. FRANCHISE TAX BOARD, an agency of the State of California, Defendant(s)	Case Number: 991237 **CERTIFICATE OF MAILING** (CCP 1013a (4))

I, Andrea Carney, a Deputy Clerk of the Superior Court of the City and County of San Francisco, certify that I am not a party to the within action.

On May 26, 1999 I served the attached Statement of Decisions by placing a copy thereof in a sealed envelope, addressed as follows:

Charles J. Moll III
Edwin P. Antolin
Morrison and Foerster
425 Market Street
San Francisco, California
94105-2482

Bill Lockyer, Attorney General
Joyce E. Hee, Deputy Attorney General
Attorney General's Office
1515 Clay Street,
21st Floor
Oakland, California
94612-1413

and, I then placed the sealed envelopes in the outgoing mail at 400 McAllister Street, San Francisco, CA. 94102 on the date indicated above for collection, attachment of

required prepaid postage, and mailing on that date following standard court practices.

Dated: May 26, 1999

ALAN CARLSON, Clerk

By: /s/ Andrea Carney
Andrea Carney, Deputy Clerk

APPENDIX C

Court of Appeal, First Appellate District,
Division Two – No. A088142
S098102

IN THE SUPREME COURT OF CALIFORNIA

En Banc

DELUXE CORPORATION, Plaintiff and Appellant,

v.

FRANCHISE TAX BOARD, Defendant and Respondent.

(Filed Jul 11, 2001)

Petition for review DENIED.

Werdegar J., was absent and did not participate.

GEORGE
Chief Justice

APPENDIX D

Public Law No. 86-272

15 USCS § 381 (2001)

§ 381. Imposition of net income tax

(a) Minimum standards. No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act [enacted Sept. 14, 1959], a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(b) Domestic corporations; persons domiciled in or residents of a State. The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to –

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) Sales or solicitation of orders for sales by independent contractors. For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible person property.

(d) Definitions. For purposes of this section –

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.

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15 USCS § 382 (2001)

§ 382. Assessment of net income taxes

(a) Limitations. No State, or political subdivision thereof, shall have power to assess, after the date of the

enactment of this Act [enacted Sept. 14, 1959], any net income tax which was imposed by such State or political subdivision, as the case may be, for any taxable year ending on or before such date, on the income derived within such State by any person from interstate commerce, if the imposition of such tax for a taxable year ending after such date is prohibited by section 101 [15 USCS § 381].

(b) Collections. The provisions of subsection (a) shall not be construed –

(1) to invalidate the collection, on or before the date of the enactment of this Act [enacted Sept. 14, 1959], of any net income tax imposed for a taxable year ending on or before such date, or

(2) to prohibit the collection, after the date of the enactment of this Act [enacted Sept. 14, 1959], of any net income tax which was assessed on or before such date for a taxable year ending on or before such date.

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15 USCS § 383 (2001)

§ 383. "Net income tax" defined

For purposes of this title [15 USCS §§ 381 et seq.], the term "net income tax" means any tax imposed on, or measured by, net income.

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15 USCS § 384 (2001)

§ 384. Separability

If any provision of this title [15 USCS §§ 381 et seq.] or the application of such provision to any person or circumstance is held invalid, the remainder of this title [15 USCS §§ 381 et seq.] or the application of such provision to persons or circumstances other than those to which it is held invalid, shall not be affected thereby.

APPENDIX E

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Mailing address:
Legal Division
P.O. Box 1468
Sacramento, CA 95812-1468
(916) 369-3337

June 8, 1990
FTB NOTICE 90-3
410:BRL:CN-90-363

Re: Sales Factor Throwback; Revenue and Taxation Code §25135

In the Appeal of Finnigan Corporation, 88-SBE-022, August 25, 1988, the State Board of Equalization (SBE) specifically ruled that the word "taxpayer" as used in Revenue & Taxation Code Section 25135(b)(2) means "all of the corporations within the unitary group." Therefore, the SBE held that when sales were shipped from California to another state by a member of a group conducting a unitary business in California, the throwback rule does not apply if any of the corporations within the unitary group is taxable in the other state. In the Appeal of Finnigan Corporation, Opn. on Pet. for Rehg., 88-SBE-022A, January 24, 1990, the SBE expressly overruled the apportionment rule announced in the Appeal of Joyce, Inc., Cal. St. Bd. of Equal., November 23, 1966, that the income attributable to the California activities of a corporation exempt from taxation by this state because of Public Law 86-272 had to be separately computed by application of the apportionment method and then

excluded from the measure of the franchise tax. In practice, the Joyce rule was accomplished by excluding from the numerator of the apportionment formula, but not the denominator, the California factors of corporations within the unitary group that were not themselves taxable by this state. Under Finnigan, this restriction no longer applies.

Accordingly, the Franchise Tax Board's administrative practice with respect to multi-entity apportionment formula rules previously governed by Joyce has now changed as follows:

1. Sales of goods shipped from California to other states are to be assigned to this state under the throwback rule only when none of the corporations within the unitary group is taxable within the destination state.

2. The California property, payroll and sales of each corporation within a unitary group will be taken into account in the apportionment of business income to this state, including amounts attributable to entities exempt from taxation in this state because of Public Law 86-272. The total business income thus apportioned to California will be assigned to the individual corporations taxable by this state by use of the "revised method" currently authorized by Legal Ruling 234, as modified in the following example.

EXAMPLE

Corporations A, B, and C are engaged in a unitary business.
Corporations A and C are taxable by California, but Corporation B is exempt from taxation in California under Public Law 86-272.

The basic computations necessary to determine the amounts of business income from California sources attributable to Corporations A and C are as follows:

COMBINED APPORTIONABLE BUSINESS INCOME $1,000,000

APPORTIONMENT FACTORS:

	TOTAL EVERYWHERE	WITHIN CALIFORNIA			
		CORP A	CORP B	CORP C	TOTAL CA
PROPERTY	$ 600,000	$ 24,000	$ 0	$ 36,000	$ 60,000
PAYROLL	400,000	14,000	0	26,000	40,000
SALES	5,000,000	150,000	450,000	400,000	1,000,000

COMBINED CALIFORNIA APPORTIONMENT FORMULA:

PROPERTY PERCENTAGE	4.00%	0.00%	6.00%	10.00%
PAYROLL PERCENTAGE	3.50%	0.00%	6.50%	10.00%
SALES PERCENTAGE	3.00%	9.00%	8.00%	20.00%
TOTAL				40.00%
AVERAGE				13.33%

BUSINESS INCOME APPORTIONED TO CALIFORNIA: $ 133,333

LR 234 "REVISED METHOD" – RELATIVE FORMULA PERCENTAGE CALCULATION

	CORP A	CORP B	CORP C	TOTAL CA
PROPERTY FACTOR %	4.00%	N/A	6.00%	10.00%
PAYROLL FACTOR %	3.50%	N/A	6.50%	10.00%
SALES FACTOR %	3.00%	N/A	8.00%	11.00%
TOTAL PERCENT	10.50%	N/A	20.50%	31.00%
AVERAGE PERCENT	3.50%	N/A	6.83%	10.33%
RELATIVE PERCENT	33.87%	0.00%	66.13%	100.00%
BUSINESS INCOME APPORTIONED TO EACH CALIFORNIA TAXPAYER	$45,161	$0	$88,172	$133,333

DRAFTING INFORMATION

The principal author of this notice is Bruce R. Langston, Senior Staff Counsel, Franchise Tax Board Legal Division. For further information regarding this notice, contact Mr. Langston at P.O. Box 1468, Sacramento CA, 95812-1468.

bcc: Information Files: Apportionment-UDITPA-Sales Factor

APPENDIX F

[LOGO]

CALIFORNIA FRANCHISE TAX BOARD
Legal Ruling No. 234 **October 27, 1959**

ALLOCATION: APPORTIONMENT OF THE CALIFORNIA INCOME OF A UNITARY BUSINESS.

> The California income of a unitary business must be divided among corporations having activities in this state, by assigning it to each corporation in accordance with the average ratio that the California factors of each such corporation bear to the total factors of the group.

The relative factor method of separating the income of a unitary business between the corporations, having activities in this state, approved by the State Board of Equalization in the Appeal of Kaiser-Frazer Sales Corporation, November 7, 1958, is revised as illustrated below.

Assume that the unitary income of a group of corporations is $1,000,000 and it does 13-1/3% of its business in California. The total factors and California factors of each member are as follows:

Denominators

	A	B	C	Total
Property	500,000	64,000	36,000	600,000
Payroll	300,000	74,000	26,000	400,000
Sales	4,000,000	600,000	400,000	5,000,000

Numerators

	A	B	C	Total
Property	24,000	-	36,000	60,000
Payroll	14,000	-	26,000	40,000
Sales	150,000	450,000	400,000	1,000,000

Under the new method of computation, this result would follow:

	A	B	C	Total
Property	4%	-	6%	10%
Payroll	3.5	-	6.5	10%
Sales	3.0	9	8	20%
Total	10.5%	9%	[20.5%]	40%
Average	3.5%	3%	[6.83$^1/_3$%]	13$^1/_3$%

Applied to income of $133,333.

A	- 3.5%	×	$1,000,000	=	35,000
B	- 3%	×	$1,000,000	=	30,000
C	- 6.83$^1/_3$%	×	$1,000,000	=	68,333
					$133,333

This method appears to produce a more accurate result than the relative factor method. If two or more corporations contribute to the earnings of the California income, the relative contributions of each [are] measured by the relationship of their California factors to the total factors of the group, rather than the ratio that the California factors bear to each other.

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Supreme Court, U.S.
FILED
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No. 01-603

In The

Supreme Court of the United States

DELUXE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

This Court recently denied the petition for certiorari filed in *Citicorp North America, Inc. & Affiliates v. Franchise Tax Board*, 83 Cal.App.4th 1403 (2000), *cert. denied*, ___ U.S. ___, 121 S.Ct. 2623 (2001). In *Citicorp*, the California Court of Appeal held that the State may constitutionally determine the California source income of the taxable members of a unitary group by using an apportionment formula that takes into account the apportionment factors of all members of the group, including the California factors of those group members that are not themselves taxable in the State. Based upon long accepted principles of apportionment of the income of a unitary business that have been upheld repeatedly by the California Supreme Court and this Court, the Court of Appeal held in *Citicorp* that the inclusion of the income generated in California by out-of-state affiliate corporations not themselves taxable by the State in determining the portion of the unitary group's income attributable to California sources did not unconstitutionally subject the income of the affiliates to tax in the State.

Against this background, a virtually indistinguishable question is presented in this case:

> May California constitutionally determine the California source income of the taxable member of a unitary group (i.e. Deluxe) by using an apportionment formula that takes into account the apportionment factors of all the members of the group, including those out-of-state group members that are not themselves taxable in the State and whose income is not

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QUESTIONS PRESENTED - Continued

subject to taxation in the State pursuant to Public Law 86-272 (15 U.S.C. § 381)?

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LIST OF PARTIES

Respondent, Franchise Tax Board, accepts the List of Parties as stated by petitioner Deluxe Corporation in the Petition for Writ of Certiorari.

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent Franchise Tax Board ("Board") respectfully requests that this Court deny the Petition for Writ of Certiorari ("Petition") of petitioner Deluxe Corporation (hereinafter, "Deluxe").

OPINIONS BELOW

The Board accepts Deluxe's statement of the Opinions Below as contained in its Petition and as reproduced at Appendix 1a-37a of the Petition.

STATEMENT OF JURISDICTION

The Board accepts Deluxe's statement of Jurisdiction as contained in its Petition.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Board accepts Deluxe's statement of the Constitutional and Statutory Provisions Involved as contained in its Petition and as reproduced at Appendix 38a-41a of the Petition. In addition, California Revenue and Taxation Code sections 23151, 24344, 25101, and 25120 through 25139 (in effect during the years in issue) are cited below

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and are set forth in Appendix App.1-App.14 of this brief in opposition.

STATEMENT OF THE CASE

This is an action for a refund of California franchise taxes brought by Deluxe for income years ended December 31, 1988 and December 31, 1989 ("years in issue"). Deluxe is a Minnesota corporation that primarily manufactured and sold checks to businesses throughout the United States during the years in issue.

Deluxe was engaged in a unitary business with two wholly owned subsidiaries, Current, Inc. ("Current") and Colwell Systems, Inc. ("Colwell").[1] Current was a Delaware corporation that conducted a mail order business, with all of its property and employees located at its principal place of business in Colorado. Colwell was a Delaware corporation that conducted a mail order business, with all of its property and employees located at its principal place of business in the State of Illinois. Neither Current nor Colwell were subject to California's corporation franchise or income tax during the years in issue and their activities in California did not exceed the activities

[1] A unitary business is a functionally integrated economic enterprise characterized by substantial mutual interdependence and a flow of value among members of the unitary group. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 178-179 (1983); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980), citing *Butler Brothers Stores v. McColgan*, 315 U.S. 501, 508-509 (1942).

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described in subsections (1) and (2) of 15 U.S.C. § 381(a) ["Public Law 86-272"].

A. California's Method of Taxing Corporations Engaged in a Multi-state Unitary Business Enterprise.

California imposes a franchise tax on every corporation doing business within the State. Cal. Rev. & Tax. Code § 23151. The measure of that tax is the corporation's net income derived from or attributable to sources within California. Cal. Rev. & Tax. Code § 25101. When a corporation conducts business with affiliated corporations as part of a larger unitary business enterprise operating both within and outside California, it is necessary to determine how much of the income of the unitary business is attributable to sources within California as opposed to outside the State. In these circumstances, business income derived from or attributable to California sources is determined on the basis of the unitary business formula apportionment method. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 162-163 (1983). This is a method of apportioning income in which a business conducted by related corporations as a single economic (unitary) enterprise and which earns income both in and out of California is treated as one unit for determining income attributable to sources within the State. The proportion of the business income of a unitary business attributable to California sources is determined by applying a three-factor apportionment formula, as outlined in the Uniform Division of Income for Tax Purposes Act ("UDITPA") adopted in California. Cal. Rev. & Tax. Code §§ 25120-25139.

California's three-factor apportionment formula is comprised of the average of three "factors": (1) sales factor; (2) payroll factor; and (3) property factor. Cal. Rev. & Tax. Code §§ 25129, 25132, 25134. The calculation of the numerator of the sales factor is at issue in this case. The *sales factor* is a fraction, the numerator of which is the sales of the unitary group made in California during the year, and the denominator of which is the unitary group's sales everywhere. Cal. Rev. & Tax Code § 25134.

For the years in issue, the apportionment factor was determined by adding the sales, property, and payroll factors, and dividing by three. Cal. Rev. & Tax. Code § 25128. The apportionment factor is then applied to the worldwide business income of the unitary group to determine the amount of business income attributable to California sources.

Once the business income of the unitary group is apportioned by formula to California under combined reporting principles, the tax status of each California taxpayer member of the unitary group as a separate and distinct legal entity is taken into account. The income attributable to California sources is allocated among the individual members of the unitary group that are California taxpayers in proportion to each corporation's factors in California. Each individual taxpayer's income attributable to California sources must be determined in order to arrive at its franchise tax liability. This process (intrastate apportionment) was unnecessary in this case because Deluxe is the only member of the unitary group that was subject to taxation in California. Thus, once the California source income from the unitary business was determined

by formula apportionment, it was properly allocated to Deluxe.

B. California's Method Of Computing the Factors of Its Apportionment Formula.

The dispute in this case involves the method by which California apportioned the Deluxe unitary group's sales under the State's three-factor apportionment formula during the years in issue. Under California law, sales are generally assigned for apportionment purposes to the State of their destination if the taxpayer is subject to taxation in that State. Cal. Rev. & Tax. Code § 25135. However, if the taxpayer is not taxable in the State of destination, the sales are "thrown back" to the State of origin. Thus, if a taxpayer ships property from another State to a purchaser in California, and the taxpayer is taxable in California, the sale is considered to be a sale in California and is included in the numerator of the sales factor. On the other hand, if the taxpayer is not taxable in California, the sale is "thrown back" to the State of origin and deemed to be a sale outside California – and thus excluded from the numerator of the sales factor – for apportionment factor purposes. The throwback rule arises from the fundamental premise of unitary business formula apportionment that all, but not more than all, of the income of a unitary business enterprise should be subject to taxation in the jurisdictions in which it does business.

During the years in issue, California determined that for purposes of apportionment, the term "taxpayer," as used in California Revenue and Taxation Code section

25135, referred not to the individual member of the unitary group that made the sale, but rather to the seller's unitary group as a whole. *Appeal of Finnigan Corporation*, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder, ¶ 401-797 (August 28, 1988); *Appeal of Finnigan Corporation* on rehearing, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder ¶ 402-524 (January 24, 1990). Accordingly, a sale made by a California seller to a purchaser in another State (*i.e.*, an "outbound sale") could not be thrown back to California if any other member of the seller's unitary group was taxable in the destination State, irrespective of whether the individual seller corporation was itself taxable there. Rather, that sale was treated as a sale in the State of its destination under section 25135 and excluded from California's sales factor numerator.

Conversely, a sale made by an out-of-state seller *into* California (*i.e.*, an "inbound sale") was not thrown back to the State of origin, even though the individual seller corporation was not taxable in California, if any other member of the seller's unitary group was taxable in California. *Appeal of the NutraSweet Company*, Cal. State Tax Rptr. (CCH) 1992-1993 (Pt. 2) transfer binder ¶ 402-524 (October 29, 1992).

C. California's Apportionment of the Deluxe Unitary Group's California Sales for the Years in Issue.

Current and Colwell, members of the Deluxe unitary group during the years in issue, both mailed catalogs to California residents from outside California. They both

had no physical presence in California and were not subject to California franchise tax. In addition, Current and Colwell's mail order activities in the State were limited to the activities described in subsections (1) and (2) of Public Law 86-272. Therefore, Current and Colwell themselves were not subject to taxation in California during the years in issue. Current and Colwell generated large amounts of revenue from their sales to California customers during each of the years in issue.

For the years in issue, Deluxe filed California franchise tax returns and determined its California net income by preparing a combined report that included the business income of all members of the Deluxe unitary group. Pursuant to the method of apportionment set forth in the *Appeal of Joyce, Inc.*, Cal. St. Bd. of Equal. (November 23, 1966), and FTB Legal Ruling No. 234, Deluxe took the position that the California sales of Current and Colwell should not be included in the numerator of the California sales factor used to determine the portion of the Deluxe unitary group's business income attributable to California sources, because Current and Colwell were not taxable in California.

After an audit, the Board determined that, pursuant to the method of apportionment set forth in the State Board of Equalization's *Finnigan*[2] decisions as applied in

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[2] *Appeal of Finnigan Corporation* ["*Finnigan I*"], No. 88-SBE-022, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder, ¶ 401-653 (8/25/88), and *opinion on reh'g, Appeal of Finnigan Corporation* ["*Finnigan II*"] No. 88-SBE-022-A, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder, ¶ 401-797 (1/24/90).

FTB Notice 90-3, the California-destination sales of Current and Colwell should be included in the numerator of the California sales factor used to determine the portion of the Deluxe unitary group's income attributable to California sources.[3] Pursuant to FTB Notice 90-3, the Board then assigned the California-source income of the Deluxe unitary group to the California taxpayer member of the group, Deluxe. None of the business income attributable to California sources was assigned to Current or Colwell because they are not taxable in California.

D. The Proceedings Below.

Deluxe filed suit for a tax refund in the San Francisco County Superior Court wherein it alleged that California's method of apportioning income resulted in the improper and unconstitutional taxation of the income of nontaxable members of its unitary business (Current and Colwell), in violation of Public Law 86-272 and the due process, commerce, and equal protection clauses of the United States Constitution. The trial court ruled that

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[3] Until the *Finnigan* decisions were decided by the State Board of Equalization, the Board followed the *Joyce* apportionment method. *Finnigan I* was decided on August 25, 1988, and applied to income years ending in 1977 and 1978. *Finnigan II* (Jan. 24, 1990) further clarified the State Board of Equalization's *Finnigan* holding and specifically overruled the *Joyce* rule of apportionment.

The Board is compelled to follow the State Board of Equalization's decisions on administrative appeal. Because the *Finnigan* decisions applied retroactively, the Board was compelled to apply the *Finnigan* apportionment method to the Deluxe unitary group and other similarly situated taxpayers.

California's apportionment method was constitutional and did not violate Public Law 86-272, and rendered judgment in favor of the Board. Appendix 13a-36a, 24a-25a, and 26a-32a of Petition.

Deluxe appealed. By unanimous decision, the California Court of Appeal affirmed the judgment. Appendix 1a-12a of Petition. Relying on *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal.App.4th 1403 (2000), the Court of Appeal held:

> We hereby adopt the well-reasoned analysis of *Citicorp* and find that analysis effectively disposes of the arguments made by Deluxe on appeal. [¶] . . . The *Citicorp* court unanimously repudiated Citicorp's contention that the *Finnigan* rule of apportionment amounts to an illegal, 'indirect' tax on the income of the South Dakota affiliate. In doing so, the court relied on *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472 (*Edison*), which held 'that to compute the income allocable to one state of a unitary business operated in several states by a reasonable formula method is not to tax extraterritorial values.' (*Id.* at p. 483, citing *Butler Brothers, supra*, 315 U.S. at p. 507.) Invoking *Edison's* reasoning, *Citicorp* concluded that 'by considering the California income of Citibank (South Dakota), the FTB is not taxing but is apportioning income attributable to California. [Citation.] Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction.' (*Citicorp, supra*, 83 Cal.App.4th at p. 1415.) The court found *Edison* to be 'a clear response to Citicorp's claim that consideration of the out-of-state affiliate's California activity

> results in extraterritorial taxation.' (*Ibid.*, fn. omitted.)
>
> In so holding, *Citicorp* reaffirmed the long-established distinction between apportionment of income and the taxation of income. Recognizing this distinction, the court determined that the income of Citibank (South Dakota) was not being taxed indirectly by California, but was simply being considered in the measure of tax, i.e., in determining the amount of Citicorp's business income attributable to California sources. Appendix 7a-8a of Petition.

The Court of Appeal also relied in *Deluxe* upon *Citicorp's* reasoning in finding that the Board's application of the *Finnigan* rule did not violate the due process, commerce, and equal protection clauses of the United States Constitution. Appendix at 10a of Petition.

The California Supreme Court denied Deluxe's Petition for Review of the Court of Appeal's decision, without comment. Appendix 37a of Petition.

REASONS FOR DENYING THE PETITION

This Court should deny review of the California Court of Appeal's decision for several compelling reasons.

First, Deluxe raises issues that have no ongoing legal significance. As of April 22, 1999, California has reverted prospectively to a previously-used apportionment method in which the California sales, property and payroll of nontaxable members of a unitary business, such as Current and Colwell, are no longer attributed to

California for purposes of computing the numerators of the group's sales, property and payroll factors.

Second, although Deluxe goes to great lengths to disguise the undeniable import of the *Citicorp* decision by characterizing the question presented in this case in a different way, the issues raised herein already have been answered by *Citicorp*, a case this court declined to review. Deluxe asserts that the *Citicorp* case involved the question of whether California constitutionally could include the sales of nontaxable corporations in the sales factor of the apportionment formula while the instant case involves a purported violation of Public Law 86-272. (*See* fn. 3, p. 13 of Petition.) This is a distinction without a difference. If, as the court in *Citicorp* held, California's inclusion of the sales income of a nontaxable member of a unitary group in the apportionment formula is not taxing that income but rather is simply apportioning the unitary group's income attributable to California, then it equally is true that California's inclusion of the sales income of the nontaxable members of a unitary group, the income of which also is not subject to tax pursuant to Public Law 86-272, in the apportionment formula is not taxing that income. Because Deluxe now concedes that California is permitted under the Constitution to include the sales of nontaxable corporations in the sales factor of the apportionment formula (Petition, fn. 3) and does not dispute the amount of income apportioned to California for the years in issue (Petition, p. 13), it necessarily follows that

California's apportionment method does not result in a violation of Public Law 86-272.[4]

Third, Deluxe's arguments reflect a fundamental misapprehension of two distinct and separate concepts (a State's right to *apportion* the income of a unitary business to determine the proper state source of that income and a state's *jurisdiction* to tax individual corporations) and loses sight of the ultimate objective of the apportionment process.

I. THE ISSUE PRESENTED TO THIS COURT HAS NO ONGOING LEGAL SIGNIFICANCE.

The foremost reason why certiorari should be denied is that the issues raised in the Petition have no ongoing legal significance in California. As of April 22, 1999, California administratively changed, on a prospective basis, its method of apportioning sales to the State by returning to a previously-used apportionment method, one in which the California sales, property and payroll of nontaxable unitary members are no longer attributed to California in computing the numerators of the unitary group's sales, property and payroll factors. *See Appeal of*

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[4] At trial Deluxe argued that the California sales of the nontaxable corporations, Current and Colwell (the income of which could not be taxed pursuant to Public Law 86-272), could not be included in the numerator of the sales factor of the apportionment formula. This is the same issue presented in the *Citicorp* case. In its petition for rehearing in the Court of Appeal and its petition for review in the California Supreme Court, Deluxe conceded this issue.

Huffy Corporation, Cal. State Tax Rptr. (CCH) ¶ 403-031 (April 22, 1999).

II. THE CALIFORNIA COURT OF APPEAL'S DECISION IS FULLY CONSISTENT WITH THE *CITICORP* DECISION AND THE WELL-SETTLED DECISIONS OF THIS COURT.

Deluxe complains that California's apportionment method "threatens to render the protections afforded by Public Law 86-272 merely illusory" and that if the decision stands "all federal limitations on the states' taxing power would be at risk." (Petition, p. 18.) Deluxe misstates the significance of the California Court of Appeal's decision, especially in light of the *Citicorp* decision. In reality, what Deluxe seeks is to erode significantly many decades of decisional authority from this Court permitting a taxing State to look beyond its borders to arrive at a fair allocation to the State of a fair share of the taxable values of the taxpayer's activities within the State. *See, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 311-12, n. 10 (1994); *Shell Oil Co. v. Iowa Dep't of Revenue*, 488 U.S. 19, 30-31 (1988); *Container Corp., supra*, 463 U.S. at 165; *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436 (1980); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959). *See generally International Harvester Co. v. Evatt*, 329 U.S. 416 (1947); *Butler Brothers Stores v. McColgan*, 315 U.S. 501 (1942); *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Underwood Typewriter Co.*

v. Chamberlain, 254 U.S. 113 (1920). Public Law 86-272 does not affect the wisdom or application of these decisions, especially where the statute itself specifically prohibits *taxation* of a specific type of income, not consideration of that income for any and all purposes, including apportionment.

Never before in cases involving state apportionment of income has a taxpayer successfully argued before this Court that a State's inclusion of the nontaxable income of a unitary group member, generated as part of the unitary business, in the apportionable income base of a unitary group member resulted in extraterritorial taxation. None of the cases cited by Deluxe that invalidated state exactions of extraterritorial income involved the apportionment of income of a unitary business.[5]

This Court has uniformly rejected such a notion on the ground that the apportionment of income is not tantamount to the taxation of income.

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[5] For example, in this Court's recent decision in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), the issue presented did not involve the proper apportionment of income of a unitary business doing business in California. Rather, the case involved the constitutionality of California's "interest offset deduction" (Cal. Rev. & Tax. Code § 24344), which, *after the apportionment of income to individual taxpayers*, operated to assign the interest expense deduction of a corporation as a deduction against nonbusiness income. This Court held that this assignment, as applied to out-of-state taxpayers with nonbusiness income not taxable in California, caused extraterritorial income to be taxed indirectly by the State in violation of the due process clause.

For instance, in *Shell Oil Co.*, 488 U.S. at 30-31, this Court stated:

> Shell's argument hinges on the mistaken premise that including OCS-derived income in the preapportionment tax base is tantamount to the direct taxation of OCS production. But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa. As our Commerce Clause analysis of apportionment formulas has made clear, the inclusion of income in the preapportioned tax base of a state apportionment formula does not amount to extraterritorial taxation. This court has repeatedly emphasized that the function of an apportionment formula is to determine the portion of a unitary business' income that can be fairly attributed to instate activities. *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219 (1980); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 440 (1980).

It follows implicitly from these decisions that when, as here, income apportioned to the State is increased by consideration of the income and factors (such as sales to California customers) of the nontaxable members of the group, any increase in the tax base is properly borne by the taxable corporations. The combined reporting process utilized by California reflects the values in the State of the integration and interdependence of the taxable and nontaxable members of Deluxe's unitary business. It does not matter that the income of nontaxable members of the

unitary group is not subject to taxation based upon both constitutional principles as well as a federal statute. Granting certiorari to affirm, yet again, what has long been a fundamental principle of state taxation law is unwarranted.

Deluxe contends that California's apportionment method resulted in taxation of the income of Current and Colwell that may not be taxed, not only according to constitutional principles, but pursuant to Public Law 86-272. Under similar factual circumstances, the appellate court in *Citicorp* held that this application of California's apportionment method which attributed to the State the credit card sales to California customers of a nontaxpayer member of Citicorp's unitary business, thereby increasing the tax base of Citicorp's members taxable in California, did not result in indirect extraterritorial taxation.

The principle of apportionment approved in *Citicorp*, that is, that a State may include the factors of nontaxable members of a unitary group in its apportionment formula, applies regardless of the reason the individual members are not taxable. In *Citicorp*, a member of the unitary group was not taxable because it lacked substantial nexus with the taxing State under the Commerce Clause. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). In this case, Current and Colwell are not taxable because of the provisions of a federal statute. The critical conclusion, present in both *Citicorp* and this case, is that California does not offend the due process or commerce clauses by including the sales and income of nontaxable unitary group members in its apportionment formula. There is no meaningful distinction between the two cases. Thus, since the application of California's apportionment method did

not result in the taxation of the income of Citibank South Dakota in the *Citicorp* case, it is equally true that California's apportionment method did not result in the taxation of the income of Current and Colwell in violation of Public Law 86-272.

This Court has stated that although constitutional limits on a State's ability to tax a unitary business exist, a State nonetheless will be allowed "wide latitude" to select a method of apportionment. *Moorman Mfg. Co.*, 437 U.S. at 274. California's three-factor apportionment formula has not only met this Court's approval against constitutional challenge made under the due process clause and the commerce clause, but has become "something of a benchmark against which other apportionment formulas are judged." *Container Corp.*, 463 U.S. at 170. When a State's apportionment method represents "a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State," no constitutional violation occurs. *Moorman Mfg. Co.*, 437 U.S. at 273. California's method of apportionment thus is fully consistent with constitutionally approved principles of apportioning income for the purposes of taxation of the members of a unitary business and also does not violate Public Law 86-272.

III. DELUXE MISAPPREHENDS THE DIFFERENCE BETWEEN APPORTIONMENT AND TAXATION.

Deluxe's argument that California's *Finnigan* apportionment method shifts the income from members of the unitary group that are immune from taxation under Public Law 86-272 to the taxable member or members of the

group in order to indirectly tax what it otherwise could not tax, is fatally flawed for several reasons, as discussed below. Deluxe's "shifting of income" argument is this: although the inclusion of Current's and Colwell's California sales in the numerator of the sales factor of the apportionment formula does not violate Public Law 86-272 or the United States Constitution, the real problem is that once the California source income is determined in Step 3 (formula apportionment), it is allocated only to the taxpayer members of the unitary group (in this case, Deluxe alone) in Step 4 (intrastate apportionment). Petition, pp. 4-6. Deluxe asserts that once the California source income is determined, that amount must be allocated not only to Deluxe but also to Current and Colwell because they are not subject to tax by California under the federal statute and the United States Constitution.

A. Deluxe's Argument That a Portion of the California Source Income Must Be Allocated Back to Current and Colwell Ignores the Fundamental Objective of Apportionment.

The ultimate objective of apportionment is to determine the portion of a unitary group's income attributable to California sources, in order to determine the tax liability of its California taxpayer members. The apportionment formula is utilized to determine how much of the income of the unitary group is attributable to sources within California as opposed to all of the other States in which the group conducts business, *for the purpose of determining the measure of tax of those corporate members of the unitary group that are subject to California tax.*

California is not interested in, nor does it calculate, the measure of tax of those corporate members of the unitary group that are not taxable in California. Where (as Deluxe concedes) California is constitutionally permitted to include the sales of nontaxable corporations such as Current and Colwell in the sales factor of the apportionment formula, the California source income thereafter is properly allocated only to the California taxpayer members of the unitary group because that is the sole objective of the entire apportionment process. Thus, Deluxe's argument that a portion of the California source income must be taken out and allocated back to Current and Colwell in the intrastate apportionment step of the process makes no sense.

B. Apportionment and Taxation are Distinct and Separate Concepts.

Deluxe's attack on California's apportionment method confuses a State's *jurisdiction* to tax with *apportionment* of income. Deluxe's contention that California's apportionment of income to Deluxe's unitary group's taxable member results in indirect taxation of exempt income solely because sales to California customers are made by nontaxable members of the unitary business, the income of which also is not subject to taxation under Public Law 86-272, is contrary to the long line of decisions of this Court approving the apportionment of income of unitary business enterprises. These decisions have consistently affirmed the fundamental unitary business principle that in apportioning the combined income of a unitary group of corporations, a State is not constitutionally barred from taking into account the income and

factors of all the members of the group, without regard to whether the members are subject to tax by the State. *Moorman Mfg. Co.*, 437 U.S. at 273. *See Barclays Bank*, 512 at 311-12 n. 10; *Shell Oil Co.*, 488 U.S. at 30-31; *Container Corp.*, 463 U.S. at 165; *Exxon Corp.*, 447 U.S. at 219; *Mobil Oil Corp.*, 445 U.S. at 436; *Northwestern States Portland Cement Co.*, 358 U.S. at 460. *See generally Butler Bros.*, 315 U.S. 501; *Hans Rees' Sons*, 283 U.S. 123; *Underwood Typewriter Co.*, 254 U.S. 113. The decision of the California Court of Appeal in this case is fully consistent with these decisions.

By asserting that California's apportionment method results in the "shifting of income" from a nontaxable corporation to taxable corporations, Deluxe necessarily is segregating the income of its unitary business enterprise into the separate income of each of the individual member corporations. This segregation can only be accomplished through separate accounting, which this Court has held "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp*, 463 U.S. at 164-165. Thus, Deluxe's argument disregards the undisputed fact that each of its unitary members, whether taxable or nontaxable in the State, constitutes an integrated part of a single unitary enterprise.

The premise of Deluxe's argument is fundamentally at odds with the underlying theory of unitary business formula apportionment as reflected in California's system of combined reporting: the separate identity of the individual members of the unitary group is disregarded for

the purpose of determining the appropriate amount of the unitary group's combined income to apportion to the taxing State. *See Mobil Oil*, 445 U.S. at 439 ["the linchpin of apportionability in the field of state income taxation is the unitary business principle"]. This Court has never focused on the taxability of an individual corporation in determining whether its inclusion in a state's apportionable income base passes constitutional muster, and Deluxe has cited no authority in support of this proposition. Rather, this Court has held that the tie between a State and a nondomiciliary corporation that conducts part of a unitary business in the State is sufficiently established by the activities of the unitary enterprise in the State to allow that State to include the nondomiciliary corporation in the apportionable income base of the unitary enterprise consistent with the commerce clause. *Id.* Thus, the attribution of Current and Colwell's "sales and transactions actually occurring in California to California . . . reasonably recognizes the contribution of the state in producing the income of the unitary group." See *Citicorp, supra*, 83 Cal.App.4th at p. 1426.

California's apportionment method neither "shifts" nor "assigns" anything from one corporation to another or from one State to another. It merely apportions to the State a portion of the Deluxe unitary group's business income which reasonably approximates the level of business conducted by the unitary group in the State. Income attributable to California sources, which is the measure of a corporation's tax liability under California statutes, is then assigned to the member or members of the unitary business taxable in the State.

Deluxe is undisputedly engaged in a unitary business. Because its business is not truly separate and distinct from the other operations of the unitary group in California, its income may not be segregated clearly and accurately from those California operations. Thus, as the California Court of Appeal properly concluded, Current and Colwell's sales to California customers, regardless of the taxable or nontaxable status of the individual members of the unitary group that carry them out, may be appropriately considered in determining the income of the unitary group that is attributable to California sources.

CONCLUSION

For all of the foregoing reasons, the petition for writ of certiorari should be denied.

Dated: December 6, 2001

Respectfully submitted,

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APPENDIX A

RELEVANT CALIFORNIA STATUTES

Cal. Rev. & Tax Code § 23151 (1988)

23151. Imposition and rate of tax

(a) With the exception of financial corporations, every corporation doing business within the limits of this state and not expressly exempted from taxation by the provisions of the Constitution of this state or by this part, shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income, to be computed at the rate of 7.6 percent upon the basis of its net income for the next preceding income year. In any event, each such corporation shall pay annually to the state, for the said privilege, a minimum tax determined in accordance with Section 23153.

(b) For calendar or fiscal years ending after June 30, 1973, the rate of tax shall be 9 percent instead of 7.6 percent as provided by subdivision (a).

(c) For calendar or fiscal years ending in 1980, the rate of tax shall be 9.6 percent.

(d) For calendar or fiscal years ending in 1981, the rate shall be determined as follows:

If the net cash collections under the Bank and Corporation Tax Law for 1979-80, as determined by the Controller, are:

Less than $2,950,000,000, the tax rate shall be 9.6 percent.

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If $2,950,000,000 or greater, but less that $3,025,000,000, the tax rate shall be 9.50 percent.

If $3,025,000,000 or greater, but less than $3,100,000,000, the tax rate shall be 9.45 percent.

If $3,100,000,000 or greater, the tax rate shall be 9.40 percent.

(e) For calendar or fiscal years ending in 1982 the rate shall be determined as follows:

If the net cash collections under the Bank and Corporation Tax Law for 1979-80 and 1980-81, as determined by the Controller, are:

Less than $6,000,000,000, the tax rate shall be 9.6 percent.

If $6,000,000,000 or greater, but less than $6,075,000,000, the tax rate shall be 9.50 percent.

If $6,075,000,000 or greater, but less than $6,150,000,000, the tax rate shall be 9.45 percent.

If $6,150,000,000 or greater, but less than $6,225,000,000, the tax rate shall be 9.40 percent.

If $6,225,000,000 or greater, the tax rate shall be 9.35 percent.

(f) For calendar or fiscal years ending in 1983 and thereafter the rate shall be determined as follows:

If the net cash collections under the Bank and Corporation Tax Law for 1979-80, 1980-81, and 1981-82, as determined by the Controller, are:

Less than $9,450,000,000, the tax rate shall be 9.6 percent.

If $9,450,000,000 or greater, but less than $9,252,000,000, the tax rate shall be 9.5 percent.

If $9,525,000,000 or greater, but less than $9,600,000,000, the tax rate shall be 9.45 percent.

If $9,600,000,000 or greater, but less than $9,675,000,000, the tax rate shall be 9.40 percent.

If $9,675,000,000 or greater, but less than $9,750,000,000, the tax rate shall be 9.35 percent.

If $9,750,000,000 or greater, the tax rate shall be 9.30 percent.

(g) For calendar or fiscal years ending in 1987 and thereafter, the tax rate shall be 9.3 percent.

Cal. Rev. & Tax Code § 24344 (1957)

§ 24344. (a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the

provisions of Section 24402) not subject to allocation by formula.

Cal. Rev. & Tax Code § 25101 (1982)

§ 25101. Derivation from domestic and foreign sources; measure of tax; apportionment.

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made.

Cal. Rev. & Tax Code § 25120 (1966)

§ 25120. Definitions

As used in Section 25120 to 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and dispositions of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

Cal. Rev. & Tax Code § 25121 (1966)

§ 25121. Taxpayers liable

Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act.

Cal. Rev. & Tax Code § 25122 (1966)

§ 25122. Tax liability in other state

For purposes of allocation and apportionment of income under this act, a taxpayer is taxable in another state if (a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Cal. Rev. & Tax Code § 25123 (1966)

§ 25123. Allocation of nonbusiness income

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 25124 through 25127 of this act.

Cal. Rev. & Tax Code § 25124 (1966)

§ 25124. Net rents and royalties

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rent and royalties from tangible personal property are allocable to this state:

(1) If and to the extent that the property is utilized in this state, or

(2) In their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the income year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the income year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payor obtained possession.

Cal. Rev. & Tax Code § 25125 (1988)

§ 25125. Capital gains and losses

(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) The property had a situs in this state at the time of the sale, or

(2) The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Except in the case of the sale of a partnership interest, capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's domicile is in this state.

(d) Gain or loss on the sale of a partnership interest is allocable to this state in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sale factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold.

Cal. Rev. & Tax Code § 25126 (1966)

§ 25126. Interest and dividends

Interest and dividends are allocable to the state if the taxpayer's commercial domicile is in this state.

Cal. Rev. & Tax Code § 25127 (1966)

§ 25127. Patent and copyright royalties

(a) Patent and copyright royalties are allocable to this state:

(1) If and to the extent that the patent or copyright is utilized by the payor in this state, or

(2) If and the extent that the patent or copyright is utilized by the payor in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states or utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

Cal. Rev. & Tax Code § 25128 (1966)

§ 25128. Allocation of business income

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Cal. Rev. & Tax Code § 25129 (1966)

§ 25129. Property factor

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year.

Cal. Rev. & Tax Code § 25130 (1966)

§ 25130 Valuation of property

Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any rental rate received by the taxpayer from subrentals.

Cal. Rev. & Tax Code § 25131 (1966)

§ 25131. Average value of property

The average value of property shall be determined by averaging the values at the beginning and ending of the income year but the Franchise Tax Board may require the averaging of monthly values during the income year if reasonably required to reflect properly the average value of the taxpayer's property.

Cal. Rev. & Tax Code § 25132 (1966)

§ 25132. Payroll factor

The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

Cal. Rev. & Tax Code § 25133 (1966)

§ 25133. Compensation paid in state

Compensation is paid in this state if:

(a) The individual's service is performed entirely within the state; or

(b) The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) Some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Cal. Rev. & Tax Code § 25134 (1966)

§ 25134. Sales factor

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

Cal. Rev. & Tax Code § 25135 (1966)

§ 25135. Situs of sales of tangible personal property

Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

Cal. Rev. & Tax Code § 25136 (1966)

§ 25136. Situs of sales of other than tangible personal property

Sales, other than sales of tangible personal property, are in this state if:

(a) The income producing activity is performed in this state; or

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(b) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Cal. Rev. & Tax Code § 25137 (1966)

§ 25137. Apportionment by franchise tax board

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Cal. Rev. & Tax Code § 25138 (1974)

§ 25138. Interpretation

This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it. Enactment of Article IV of the Multistate Tax Compact (as set forth in Section 38006 of the code)

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pertaining to the allocation and apportionment of income shall be construed as a reenactment of Sections 25120 to 25137, inclusive, without any inference that a change in interpretation is implied by such enactment.

Cal. Rev. & Tax Code § 25139 (1966)

§ 25139. Short title

Sections 25120 to 25139, inclusive, may be cited as the Uniform Division of Income for Tax Purposes Act.

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No. 01-603

IN THE

Supreme Court of the United States

DELUXE CORPORATION,
Petitioner,

v.

FRANCHISE TAX BOARD,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of California, First Appellate District

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITION

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On Petition for a Writ of Certiorari to the Court of Appeal of California, First Appellate District

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITION

INTEREST OF THE *AMICUS CURIAE*

The Council On State Taxation (COST)[1] submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[2] COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities.

[1] COST was previously the Committee On State Taxation but changed its name to the Council On State Taxation by vote of its membership November 6, 2001.

[2] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent has been obtained and filed with the Clerk of the Court.

COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of approximately 550 multistate corporations involved in interstate and international commerce. COST's members' interest in this case is both specific and general. All COST member companies either do business in California or are subject to corporate income tax in states with statutes similar to those of California.[3] Specifically, COST members hope that the Court will clarify the Congressional intent of Public Law 86-272,[4] and prevent California from indirectly imposing taxes on income of multi-jurisdictional taxpayers (via the unitary business theory) which it is precluded from doing directly (via Public Law 86-272). Without such guidance, States will continue to run afoul of Congress's overt efforts to facilitate interstate commerce.[5] Because of the unique impact of Public Law 86-272, this case presents the Court with the opportunity

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[3] We are aware of five other states (Arizona, Indiana, Kansas, Utah, and New York) that follow California's lead by ignoring the rule of Public Law 86-272. *See Airborne Navigation Corp. v. Ariz. Dep't of Rev.*, No. 395-85-I, 1987 Ariz. Tax LEXIS 34 (Feb. 5, 1987); Ind. Dep't of Rev., Informational Bulletin No. 12, 1988 Ind. Tax LEXIS 27, June 1988, *revised* Nov. 1993; Kan. Dep't of Rev., Kan. Rev. Rul. 12-91-1, Kan. St. Tax Rptr. ¶ 18-735, Feb. 1, 1991; Utah Admin. Code 865-6F-24. New York is currently litigating the issue.

[4] Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified *as amended* at 15 U.S.C. § 381 *et seq.* (1994))

[5] As this Court noted in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), Congress has explicit Constitutional authority to regulate interstate commerce. Even so, Congress rarely exercises its prerogative, and, other than Public Law 86-272, has not given the states guidance on the taxation of multistate businesses. In such a near vacuum, states cannot be allowed to ignore the authority Congress *has* given.

to interpret the interplay between Constitutional and federal statutory law not presented in *Citicorp N. Am. Inc. v. Franchise Tax Bd.*[6]

In the instant matter, the key inquiry before the Court is whether California is able to abandon its general rule of tax determination (solely because one or more members of a unitary group are protected from income tax under Public Law 86-272), and apply a scheme that taxes income Congress has explicitly protected. The Franchise Tax Board, operating without sufficient guidance from this Court, has rendered the statutory tax jurisdiction concepts powerless as applied to a unitary group. Its action subjects income protected by Public Law 86-272 to tax by assigning the income to members of a unitary group that have nexus in California. By doing so, California violates the Congressional protection for interstate activities. Further, despite this Court's holdings regarding retroactivity of judicial decisions, California has unilaterally applied its judicial decision interpreting the function of a federal statute on a prospective basis only. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993); *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971). By granting the Petition for Certiorari, this Court can reassert the validity of the Congressionally enacted safe harbor of Public Law 86-272 and can establish proper standards for inclusion of income consistent with federal and constitutional limitations on the states.

SUMMARY OF THE ARGUMENT

Public Law 86-272 limits states' ability to tax income from outside their territorial boundaries. States may subject a multi-jurisdictional taxpayer's income to tax if the

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[6] 83 Cal. App. 4th 1403, 100 Cal. Rptr. 2d 509 (2000), *cert. denied*, ___ U.S. ___, 121 S.Ct. 2623 (2001). The facts in *Citicorp* are similar to the facts of the present case except for the monumental difference that the taxpayer in the present case is protected by Public Law 86-272 whereas the taxpayer in *Citicorp* did not have such federal statutory protection.

income arises from a unitary business; however, states such as California may not use the unitary business theory to circumvent a federal statute that otherwise explicitly protects the income from taxation. The fact that an entity is unitary with a group of entities does not, *a fortiori,* render the entity taxable in each state where any member of the group has nexus. To reach such a conclusion is to transmute unitary theory into nexus theory. Both legislative and judicial histories overwhelmingly establish that the federal statute, Public Law 86-272, is precisely geared towards protecting multi-jurisdictional taxpayers in this exact scenario. Recently, a somewhat similar matter was brought before this Court in *Citicorp*, but the taxpayer in that case did not have the benefit of Public Law 86-272 protection. In the present case, the statutory protections cannot be understated. Public Law 86-272 is the result of the recognition by Congress, as well as decisions by this Court subsequent to the passing of the statute, that the states' interest in taxing certain business activities is weaker than the national interest in promoting an open economy. *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275 (1972). Confounding matters further, California has inconsistently applied its interpretative decisions concerning Public Law 86-272. In 1966, California first adopted the "Joyce" rule holding that the income of protected members of a unitary group would be excluded from the apportionment factor. *Appeal of Joyce, Inc.,* No. 66-SBE-069 (Cal. St. Bd. of Equal., Nov. 23, 1966). Then, in 1990, California switched its position and applied new analysis that *included* the income protected by Public Law 86-272 in the apportionment formula of a unitary group. It chose to apply this ruling retroactively. In 1999, in another about face, California readopted its original ruling but applied this analysis *prospectively.* Such treatment is not only arbitrary but has also caused great uncertainty among taxpayers. Therefore, this Court's guidance is needed to validate and reassert the power of Public Law 86-272 when states attempt

to use the unitary business doctrine to circumvent it, and to clarify whether the Franchise Tax Board properly applied its 1999 judicial decision prospectively in its interpretation of Public Law 86-272. Such guidance would reestablish needed certainty for the compliance and return preparation efforts of multi-jurisdictional taxpayers who have come to rely on the well founded principles Congress adopted in Public Law 86-272.

ARGUMENT

I. CALIFORNIA CANNOT UTILIZE THE UNITARY BUSINESS PRINCIPLE TO CIRCUMVENT THE CONGRESSIONALLY CREATED INCOME TAX SAFE HARBOR OF PUBLIC LAW 86-272.

A. By enacting Public Law 86-272, Congress unequivocally intended to end the uncertainties surrounding taxing jurisdiction nexus standards by creating a national safe harbor.

The Commerce Clause limits a state's ability to tax a nondomiciliary corporation's multi-state income. U.S. Const. art. I, § 8, cl. 3. Consistent with these constitutional limitations, a state's ability to tax income earned by a multistate business requires a "minimal connection" between the interstate activities of the corporation and the taxing state. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978)); *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954). Public Law 86-272 originates from the great uncertainty that developed in 1959 from the multitude of definitions which constituted a "minimal connection." *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) (holding that nexus existed where taxpayer rented an office in the state in which it solicited sales); *Brown-Forman Distillers Corp. v. Collector*

of Revenue, 234 La. 651 (1958), *appeal dism'd*, 359 U.S. 28 (1959) (holding that nexus existed where taxpayer neither rented nor owned property in the taxing state and only occasionally visited the state); *International Shoe Co. v. Fontenot*, 236 La. 279 (1958), *cert. denied*, 359 U.S. 984 (1959) (holding that nexus existed where taxpayer neither rented nor owned property in the taxing state but regularly and systematically solicited orders for sales).

Within months of the decision in *Northwestern*, and subsequent refusals by the Court to disturb the Louisiana Supreme Court decisions in *Brown-Forman* and *International Shoe*, Congress responded to the "considerable concern and uncertainty" and "serious apprehension" in the commercial community, and passed Public Law 86-272. *Heublein*, 409 U.S. at 279. The Court, in *Heublein*, recalled the Congressional concerns as follows:

> Persons engaged in interstate commerce are in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient . . . . connection with the State to support the imposition of a tax on net income from interstate operations and 'properly apportioned' to the State.

Id. at 280, n.5 (quoting S.Rep. No. 658, 86th Cong., 1st Sess., 2-3 (1959)). Despite the historic reluctance of Congress to entertain federal legislation in the area of state taxation of interstate commerce, the magnitude of the concern to erase the existing uncertainties prompted Congress to assert its authority to regulate interstate commerce by passing Public Law 86-272. Public Law 86-272 establishes that a state may not impose its income tax upon the income of a taxpayer whose only activity carried on within the state is solicitation of orders for the sale of tangible personal property, if these orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside

the state.[7] Since 1959, multi-jurisdictional taxpayers have relied on the settled expectation that activities falling within the confines of the statute may not be the subject of a state tax measured by their income. This expectation has guided tax return preparation and compliance efforts of taxpayers in every state. California, and states that follow its lead, should not be allowed to simply ignore when Congress acts (rare as it is) to protect interstate commerce.

B. California circumvents the Congressional safe harbor under the guise of the unitary business principle.

California does not dispute that the activities of Deluxe's subsidiaries and the resulting income fall within the protections of the statutory parameters of Public Law 86-272. Nevertheless, California ignores the federal statute and seeks to subject the protected income to taxation by assigning the income to the members of Deluxe's unitary group that do not have federal protection. Such a scheme is the result of the California's view of *Appeal of Finnegan Corp.*, No. 88-SBE-022-A (Cal. St. Bd. of Equal., Jan. 24, 1990), which was formally adopted by California Franchise Tax Board Notice 90-3, dated June 8, 1990 (hereinafter the "*Finnegan*" rule).

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[7] Public Law 86-272 provides in relevant part: "§ 381 Imposition of net income tax. (a) Minimum standards. No state or political subdivision thereof, shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

Under this scheme, California is able to utilize an "alternative apportionment" when the general apportionment formula results in income being assigned to an entity within the unitary group but protected by federal statute. The "alternative apportionment" then attributes such income to those entities within the unitary group that are not protected by federal statute. Were the state to respect the protection afforded by Public Law 86-272, it is clear that the group's California tax liability would be significantly less than it is presently. The result of California's approach in the instant case, therefore, is that California has imposed tax directly on income that it is not allowed to tax directly. *See Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 468 (2000). Similar to the result in *Hunt-Wesson*, California has taken the position that it may assign ***all*** unitary business income to entities over which it has jurisdiction, ignoring that some of the income should properly be attributed to other members of the group which it is statutorily precluded from taxing.

The Constitutionally based unitary business principle is strictly a theory of apportionment. It was not meant to be a blanket rule of jurisdiction to tax. In the instant case, all business income of the unitary group, which is comprised of Deluxe and its subsidiaries, form the apportionable tax base. To respect Public Law 86-272, California either must exclude the protected members' numerators from the apportionment formula or must designate a reasonable portion of the resulting apportioned base to the protected member and thus exclude it from tax. California refuses to follow either method just described, and in the process, circumvents the purpose and principle of Public Law 86-272. The issue is not one of apportionment but whether California can tax the income of federally protected companies. If the Court allows this practice to continue, Public Law 86-272 will eventually be rendered useless and the business community will be subject to the compliance problems and uncertainty that existed in 1959.

Congress adopted Public Law 86-272 long after this Court began applying the unitary business principle. See *Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185 (1897). If Congress had intended to limit Public Law 86-272 protection to stand-alone businesses, Congress could easily have done so in the statute. Rather, the statute as written provides absolute protection from taxation for qualifying entities and their income, including those entities that are part of a unitary business. California cannot include such protected income in the numerator of the apportionment formula or assign the resulting tax base solely to taxable members of the unitary group in clear violation of Public Law 86-272.

C. California's vacillating interpretation of Public Law 86-272 subjects taxpayers to inconsistency and punishes out-of-state companies.

Underlying the problem in the instant case is that California has announced a change of its rule twice since 1966 and has applied the changes retroactively and prospectively in an inconsistent fashion designed to disadvantage out-of-state taxpayers. For 24 years, since California first established the Joyce rule, the standard in California was that receipts of entities not taxable by California, such as those protected by Public Law 86-272, were not included in the numerator of the sales factor of California's apportionment factor. The *Joyce* rule, however, was reversed in 1990 by the *Appeal of Finnegan Corp.*, which included in the numerator the sales of all entities in a unitary group, including those entities that were protected by Public Law 86-272. For nine (9) years thereafter, California's practice was to overlook Public Law 86-272 and to circumvent the protection it afforded to qualifying entities of a unitary group by including their receipts in the numerator of the apportionment formula and assigning their income to unprotected members of the group. Furthermore, California applied the *Finnegan* rule retroactively to taxpayers with tax years open under the

statute of limitations. The retroactive application of *Finnegan* was intended to punish out-of-state taxpayers by allowing the State to assess tax on income of entities protected by Public Law 86-272.

In 1999, in *Appeal of Huffy Corp.*, No. 99-SBE-005-A (Cal. St. Bd. of Equal., Sept. 1, 1999), California reversed itself and restored the *Joyce* rule in favor of the problematic *Finnegan* rule. California, however, arbitrarily refused to apply *Huffy* retroactively, as was the case with *Finnegan*, but rather applied *Huffy* prospectively only. The practical effect of the prospective application of *Huffy* was to mandate taxpayers to file franchise tax returns under a methodology California has acknowledged as improper and an incorrect interpretation of Public Law 86-272. In addition, California used prospective application of *Huffy* to continue the disadvantage imposed on out-of-state taxpayers under *Finnegan.* With regard to the instant case, California's seemingly endless quest for revenue from out-of-state companies has created a paradox where the Deluxe subsidiaries in question correctly filed their tax returns in 1988 and 1989, pursuant to the *Joyce* rule, (which would currently be considered correct pursuant to *Huffy),* but the returns are considered incorrect under California's retroactive application of *Finnegan.* The nine (9) year *Finnegan* aberration catches taxpayers such as Deluxe in an inequitable and uncertain position and presents to this Court the vital opportunity to assess the unitary business theory as retroactively applied in disregard of Public Law 86-272.

The California Court of Appeals, in *Citicorp*, reviewed the validity of the prospective treatment of *Finnegan* and declined to disturb the decision in *Huffy* to remain prospective. That court, though, neither offered its own analysis of the issues nor considered the impact of Public Law 86-272. The court properly recognized that the general rule for judicial opinions is that they are fully retroactive and that

civil decisions "must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate the announcement of the rule. *Citicorp*, 83 Cal. App. 4th at 1422 (citing *Harper*, 509 U.S. at 97). Accordingly, the court identified the following factors when not following the general rule and dealing with the issue of nonretroactivity:

> First the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed . . . the second factor considers whether in light of the 'history, purpose, and effect' of the rule in question its operation will be furthered or retarded by retrospective application . . . the third factor weighs the 'inequity imposed by retroactive application' and whether it would produce . . . substantial inequitable results, . . . injustice or hardship.

Id. at 1423 (citing *Chevron*, 404 U.S. at 106-07). In applying these factors to the decision in *Huffy*, the Court of Appeals stated that a new principle of law had been established; however, this so-called new principle was one that had been in effect for the previous 24 years under the *Joyce* rule. This is hardly a new principle but rather the restoration of an older principle. Arguably, the *Finnegan* rule *could* have been applied nonretroactively, but California chose not to do so. It should not have such a choice with respect to *Huffy*. The Court of Appeals further stated that the second factor had been met since the history, purpose, and effect of the *Finnegan* rule was an attempt to lead a movement towards uniformity; however, the presence of Public Law 86-272 demonstrates the real impetus of *Finnegan* was to attempt to alleviate the scenario where entities of a unitary group would have otherwise protected income. Finally, the third factor supports prospective application if there are substantial inequitable results from retroactivity. The Court of Appeals

only looked at Citicorp's refund opportunity; rather, the court should have looked at taxpayers currently under audit or with open tax years, and at the inequitable results where *Finnegan's* application serves to circumvent Public Law 86-272. In the instant case, California twice applied its decisions to the benefit of the State Treasury and detriment of out-of-state taxpayers, and has not sought to prevent inequities from its disregard of a direct federal statute.

In *Harper*, this Court restricted nonretroactivity further than in *Chevron* when the judicial decision involves a federal law. *Harper*, 509 U.S. at 100. In *Citicorp*, the Court of Appeals declined to apply the analysis asserted in *Harper* because the issue, in *Citicorp*, only involved constitutional nexus. There was no federal law to be interpreted. In the instant case, the presence of Public Law 86-272 serves to further restrict nonretroactivity and, consequently, absolutely distinguishes this petition from the petition in *Citicorp*. Review by this Court is warranted by the violation of Public Law 86-272 and by California's changing position on the issue.

COST is concerned that if this Court allows California to vacillate on its application of the rules, with ***no*** underlying change in the statute, the administrative agency responsible has license to mislead the public, change its legal position at will, and suffer no ramification.[8] Having twice interpreted the taxing statutes to provide for a *Joyce* approach to unitary groups, California cannot be allowed to impose retroactive application of the *Finnegan* rule when such an approach

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[8] California is not the only state guilty of such behavior. Rather than dealing with its own error prospectively, the Michigan Department of Treasury retroactively assessed taxpayers that had relied on two Revenue Administrative Bulletins promulgated by the department when the Michigan Supreme Court, *sua sponte*, determined that the bulletins were incorrect. *See Gillette Co. v. Dep't of Treasury*, 497 N.W.2d 595, *cert. Denied*, 513 U.S. 1103 (1995).

violates Public Law 86-272 and the state's obligation to interpret the *Finnegan* rule consistent with the underlying, and unchanged, statutory scheme. The presence of Public Law 86-272 demands that the *Joyce* rule, as reasserted and restored in *Huffy*, be applied retroactively.

CONCLUSION

For the reasons stated above, COST respectfully requests the Court to accept this case for review and prohibit states like California from circumventing Congressional action by assigning all income of a unitary group to those entities over which the state has jurisdiction, contrary to a specific federal statute. States can not be allowed to usurp Congressional authority by misinterpreting the (only significant) federal statute on state taxation passed by Congress to protect interstate commerce.

Respectfully submitted,

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Supreme Court, U.S.
FILED
DEC 17 2001
CLERK

(6)

No. 01-603

In The

Supreme Court of the United States

DELUXE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

REPLY BRIEF FOR PETITIONER

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15 pp

RULE 29.6 STATEMENT

Deluxe Corporation does not have a parent company, nor does any other publicly held company own 10% or more of Deluxe Corporation's stock.

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REPLY BRIEF FOR PETITIONER

Respondent makes essentially three points in its Brief in Opposition: (1) that petitioner is challenging settled principles of formula apportionment and this Court's settled decisions upholding those principles (Brief in Opposition ("Br. Op.") i-ii); (2) that respondent's shifting of income from Current and Colwell to Deluxe is consistent with the principles of apportionment (*id.* 13-17); and (3) that this case does not present an issue of ongoing legal significance. (*Id.* 12-13.) None of these points has substance.

First, petitioner is not challenging the unitary business principle or formula apportionment. The petition makes this clear (Petition ("Pet.") 5), and despite arguing to the contrary, respondent eventually acknowledges this point in its brief. (Br. Op. 17-18.) The only issue raised by petitioner is whether California's method of calculating Deluxe's income runs afoul of this Court's warning in *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275 (1972), that a State may not "evade" the purpose of 15 U.S.C. § 381 ("Public Law 86-272"). Respondent's repeated efforts to recast the issue in this case are an obvious attempt to redirect this Court's attention to matters that are not in dispute.

Second, there is no merit to respondent's contention that the arbitrary shifting of income from Current and Colwell to Deluxe is constitutionally tolerable under the relaxed standards this Court has applied to constitutional challenges to unitary taxation and formula apportionment. *See, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994). Those decisions merely uphold the unitary method and formula apportionment; they do not, as respondent contends, "implicitly" support the shifting of income at issue here. (Br. Op. 15.) Third,

respondent's attempt to discount the significance of this case is belied by the interest of amicus and the need to clarify whether States may in effect override a limitation of state taxing power enacted by Congress.

Respondent has made no serious effort to defend the arbitrary shifting to Deluxe of income attributable to Current's and Colwell's California activities. Respondent does not even address this issue until the tail end of its brief, where it advances the strained argument that the shifting of income is required because the State has no "interest" in calculating the income of nontaxable corporations (Br. Op. 19), and then it merely repeats the point that the shifting of income is supported by formula apportionment principles. (*Id.* 19-22.)

I. THIS COURT'S "UNITARY TAXATION" AND "FORMULA APPORTIONMENT" CASES HAVE NO BEARING ON THE ISSUE RAISED BY THIS CASE

Throughout its brief and using different formulations, respondent repeatedly mischaracterizes the issue in this case as whether California has properly apportioned the income of Deluxe's unitary group to that State: "may California constitutionally determine the California source income of the taxable member of a unitary group (*i.e.*, Deluxe) by using an apportionment formula that takes into account the apportionment factors of all members of the group" (Br. Op. i); "[t]he calculation of the numerator of the sales factor is at issue in this case" (*id.* 4); "[t]he dispute in this case involves the method by which California apportioned the Deluxe unitary group's sales under the State's three-factor apportionment formula" (*id.* 5); and "what Deluxe seeks is to erode significantly many decades of decisional authority from this

Court permitting a taxing State to look beyond its borders to arrive at a fair allocation to the State of a fair share of the taxable values of the taxpayer's activities within the State." (*Id.* 13.)

If respondent's characterization of the issue in this case were accurate, petitioner would not be here. Petitioner takes no issue with the widely accepted principle that the income of all members of a unitary group, including the income of nontaxable corporations, is includible in a unitary group's "pot" of income subject to apportionment (Pet. 5); *see, e.g., Shell Oil Co. v. Iowa Dep't of Revenue,* 488 U.S. 19 (1988). Petitioner also does not take issue with California's apportionment formula, including the inclusion of the California sales of nontaxable corporations in the numerator of the sales factor. (Pet. 5.) Petitioner further does not dispute that the amount of the Deluxe unitary group's income apportioned to California in this case was correct and properly reflected the California activities of Deluxe, Current, and Colwell.

What petitioner does dispute, however, is respondent's arbitrary assumption that all of the unitary group's income was solely attributable to Deluxe. Respondent has provided no reasoned basis for the assumption that Deluxe earns all of the group's California income, if Current and Colwell are not taxable, but only a portion of the group's California income, if all are subject to tax.

The indefensibility of respondent's rule that shifts income from nontaxable affiliates to taxable ones has understandably induced respondent to attempt to redirect the focus of its argument from a question petitioner has raised – whether the shifting of income from Current and Colwell to Deluxe violates Public Law 86-272 – to a question petitioner has not raised – whether the unitary

business principle and California's three-factor apportionment formula properly apportioned to California the income of the Deluxe unitary group. (*See* Br. Op. i.) Respondent's goal in redirecting the inquiry is transparent – it seeks to place itself under the umbrella of this Court's decisions that, recognizing the difficulty of ascertaining precisely what share of a group's worldwide income should be assigned to a particular State, have upheld the unitary business principle and formula apportionment. (*Id.* 13-14.) Those cases upholding fair apportionment, and their forgiving constitutional standards, have no application here.

As noted in the petition and in respondent's brief, unitary taxation in California is a four-step process. The cases cited by respondent address only the first three steps of the four-step process – step one, who can be included in the unitary group (Br. Op. 13 (citing *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994))); step two, what income may be included in the pot to be apportioned among the States (Br. Op. 13 (citing *Shell Oil Co., supra* and *Butler Bros. v. McColgan*, 315 U.S. 501 (1942))); and step three, the constitutionality of the apportionment formula. (Br. Op. 13 (citing *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) and *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931))).

None of the cases cited by respondent have addressed the fourth step – the assignment of the unitary group's California income to each individual member of the group. In the present case, the sole issue before the Court relates to the fourth step – namely, whether respondent's arbitrary assignment of income is an indirect means of taxing the income of Current and Colwell, in violation of Public Law 86-272. *See Heublein, supra*. The decisions relied upon by respondent neither implicitly

nor explicitly considered whether it is proper for a State to assign a unitary group's apportioned income on a pro rata basis when all of the members of the unitary group are taxable, but to abandon the pro rata rule and assign all of that income only to taxable members when one or more of the members are immune from taxation. The authorities relied upon by respondent are simply inapposite to the primary issue here.

In short, this case does not involve, as represented by respondent, a challenge to unitary taxation or formula apportionment principles. Rather, it involves a challenge to a flawed mechanism that assumes that 100 percent of the income that has been apportioned to California is taxable by that State, regardless of whether any of that income is earned by corporations immune from California tax under Public Law 86-272. This is a question of first impression for this Court and of substantial significance in the field of state taxation.

II. RESPONDENT'S CONTENTION THAT THE SHIFTING OF INCOME FROM CURRENT AND COLWELL TO DELUXE IS SIMPLY A FUNCTION OF APPORTIONING INCOME OF A UNITARY GROUP CANNOT WITHSTAND SCRUTINY

It is undeniable that "Deluxe is paying taxes on income generated in California by Current and Colwell." (Statement of Decision (Appendix ("App.") 21a).)[1]

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[1] Indeed, even respondent acknowledges that the group's California apportioned income was assigned solely to Deluxe because it was taxable, and not to Current and Colwell because those corporations were not taxable in California. (Br. Op. 8.); *see also* Cal. Franchise Tax Bd., Notice No. 90-3 (June 8, 1990) (App. 42a) (explaining that the normal pro rata assignment of a

Respondent provides no meaningful defense of its shifting of income in this case. Its primary defense – that petitioner "misapprehends" the distinction between apportionment and taxation – is wholly without merit. (Br. Op. 17-22.)

Petitioner does not misapprehend the distinction between apportionment and taxation. Apportionment is simply the determination of the unitary group's income that is sourced or attributable to a particular State. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983). Taxation, on the other hand, involves a separate analysis of the State's power to tax the apportioned income. Indeed, this Court has made clear that taxation occurs after the apportionment process.

> [I]ncome that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. *Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable [to the state's] taxing jurisdiction is taxed by the [State].*

Shell Oil Co., supra at 30 (emphasis added).

In this case, respondent's position rests on the mistaken premise that once a unitary group's income is apportioned to California, it does not matter to which corporation that income is assigned because California may tax all of the unitary group's apportioned income, even that income attributable to corporations protected by Public Law 86-272. (Br. Op. 21 ("Income attributable to California sources, which is the measure of a corporation's tax liability under California statutes, is then

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unitary group's California apportioned income to each member of the group does not apply when a member is immune from tax in California under Public Law 86-272).

assigned to the member or members of the unitary business taxable in the State.").) The critical fault in respondent's premise is that it assumes apportionment and taxation are one and the same. However, just because income is apportioned to California does not mean California may tax that income. Since apportionment and taxation are separate and distinct concepts, California must separately determine whether it has the power to tax the income apportioned to that State. It is respondent, therefore, that misapprehends the essential distinction between apportionment and taxation.

Moreover, respondent's reasoning that the assignment of the California apportioned income solely to Deluxe is required because "California is not interested in, nor does it calculate, the measure of tax of those corporate members of the unitary group that are not taxable in California" (Br. Op. 19) is nonsensical. Even if California has no interest in calculating the income of a nontaxable corporation, it does not follow that California may shift that corporation's income to a taxable corporation and tax that income. That income is simply beyond California's taxing power. *See* 15 U.S.C. § 381; *see also Heublein, supra* at 278.

Respondent further contends that it is proper to assign the apportioned income solely to Deluxe "because [such an assignment] is the sole objective of the entire apportionment process." (Br. Op. 19.) The assignment or shifting of income at issue here is not the "sole objective" of the apportionment process, nor is it even related to that process. This Court has declared that the apportionment process is merely to "determine the portion of a unitary business' income that can be fairly attributed to in-state activities." *Shell Oil Co., supra* at 31 (citing *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 219

(1980); *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 440 (1980)). The shifting of income at issue here occurs after the apportionment process is completed. Moreover, even assuming, *arguendo*, that the state's objective in apportioning income is to assign apportioned income solely to taxable members, the mere furtherance of a state objective cannot save the state's practice from constitutional scrutiny.

Similarly, there is no merit to respondent's contention that it is not possible to segregate each unitary member's income, and therefore it is not possible to assert that income has been shifted from one member to another. (Br. Op. 20.) This defense ignores the state's own rules, which require that a unitary group's income apportioned to California be assigned to each member and reported on each member's tax return, and is belied by respondent's own statements. (*See Id.* 4, "Each individual taxpayer's income attributable to California sources must be determined in order to arrive at its franchise tax liability."); *see also* Cal. Franchise Tax Bd., Legal Ruling No. 234 (Oct. 27, 1959) (App. 47a) (providing for the assignment of apportioned income to each member of a unitary group).

Accordingly, not only is it possible to segregate each unitary member's share of the group's California income, each member is required to do so and does so based on its relative California factors compared to the California factors of the group to arrive at its individual California tax liability. Thus, there is also no merit to respondent's assertion that petitioner is arguing that each corporation's income be computed on a separate accounting basis. (Br. Op. 20.) This assertion is merely another misguided attempt by respondent to recast the issue in this case as a challenge to unitary taxation and formula apportionment principles.

III. THIS CASE HAS PROFOUND STATE AND NATIONAL SIGNIFICANCE

Respondent's contention that this case does not present issues of "ongoing legal significance" is without merit. (Br. Op. 12.) Indeed, respondent's attempt to minimize the significance of this case is belied by the amicus curiae brief filed by the Committee on State Taxation ("COST") urging the Court to grant Deluxe's petition. COST has a membership of over 500 multistate corporations involved in interstate and international commerce. The intense interest COST and its members have expressed in this case, and their deep concern over its widespread implications, demonstrate the national importance of this controversy.

Moreover, the lower court's decision establishes a rule of far-reaching import: once income of a unitary group has been apportioned to California, the State is free to tax 100 percent of such income, even though some of that income is attributable to corporations immune from taxation under Public Law 86-272. This issue has profound national implications for essential constitutional limitations on state taxing power and for Congress's power to regulate state taxation.

Finally, respondent's recently issued regulations provide no reason for this Court to refrain from granting the petition. It is a "well-settled" rule that "a defendant's voluntary cessation of a challenged practice does not deprive a federal court of its power to determine the legality of the practice." *See Northeastern Florida Contractors v. Jacksonville*, 508 U.S. 656, 662 (1993); *City of Mesquite v. Aladdin's Castle, Inc.*, 455 U.S. 283, 289 (1982). Applying this settled principle, this Court in *City of Mesquite* concluded that although the challenged statute had been eliminated while the case was pending in the Court

of Appeals, the case was not moot, because the defendant's "repeal of the objectionable language would not preclude it from reenacting precisely the same provision if the District Court's judgment were vacated." *City of Mesquite, supra* at 289.

The reasoning applied in *City of Mesquite* applies with even more compelling force here. Although the new regulations attempt to cure the taxation of corporations that have California sales and that are protected by Public Law 86-272, the regulations do not provide the same treatment for nontaxable corporations with California property and payroll. Thus, even after the new regulations are taken into account, California would continue to tax income protected by Public Law 86-272. (Pet. 6 n.1.) Moreover, since respondent's new regulations apply prospectively only, they do not cure the violation of Public Law 86-272 that is the core issue here. Cal. Code Regs. tit. 18, §§ 25106.5(c)(7) and 25106.5(g).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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